

09 / 3

Financial Services Authority

Mortgage Market Review

October 2009

Contents

Foreword	3
Acronyms	5
1 Overview	7
2 Macroeconomic background	17
3 Prudential reform	23
Impact of overall capital and liquidity reforms on the mortgage market	23
Prudential vs. conduct of business levers	30
High-risk lenders	32
4 Conduct of Business reform	36
Product regulation	36
Sales regulation	50
5 Distribution and advice	59
Advice and selling standards	61
Extending the Approved Persons regime	65
Retail Distribution Review (RDR) read-across	67
6 Disclosure and changing consumer behaviour	72
Reform of disclosure	72
Changing consumer behaviour	73
Financial capability	75
7 Arrears and repossessions	78
8 Unfair charging practices and price regulation	82
9 Scope extensions	84

10	Other matters for discussion:	90
	Sales of mortgage books	90
	Reporting requirements	90
	Financial crime and mortgage fraud prevention	94
	Equity release	96
	Right-to-Buy	97
	EU policy dependencies	100

Annex 1: List of questions

Annex 2: Cost benefit analysis

The Financial Services Authority invites comments on this Discussion Paper. Please send us your comments to reach us by 30 January 2010.

Comments may be sent by electronic submission using the form on the FSA's website at (http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/dp09_03_response.shtml).

Alternatively, please send comments in writing to:

Lynda Blackwell
 Conduct Policy Division
 Financial Services Authority
 25 The North Colonnade Canary Wharf London E14 5HS

Telephone: 020 7066 0168
 Fax: 020 7066 0169
 E-mail: dp09_03@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Discussion Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Foreword

Just over a year ago, the global financial system was on the brink of collapse and we have witnessed enormous disruption in the UK mortgage market as a result. Much of our work over the past year has been devoted to dealing with the immediate challenges the crisis brought – to ensure the prudential soundness of the financial system and restore confidence in the financial markets.

Whilst public attention has often been focused on prudential issues and the sustainability of the market, we have remained equally focused on conduct of business issues, seeking to protect consumers not only by ensuring that the financial system is prudentially sound, but also by ensuring that firms conduct their business fairly. Both have been clear objectives of our review of the mortgage market: to ensure we have a mortgage market that works better for consumers and a market that is sustainable for all participants.

We recognise that the market has worked well for many consumers: the vast majority of mortgage borrowers will come through this recession meeting their mortgage payments and keeping their homes. But it has been a cause of major economic distress for others. As we discuss in this paper, our existing regulatory framework has proved to be ineffective in constraining particularly risky lending and unaffordable borrowing and clearly there is a need to address this. So, we propose a fundamental change in our approach in the mortgage market.

This reflects the FSA's changed approach overall to supervision and risk assessment. Following the reforms we have made over the last two years, we are now equipped to analyse both conduct and prudential risk in any given sector in a way that we were not able to do before. This enables us to ensure we have considered all aspects of change both on the market and all its users; consumers and firms.

So, business model analysis will be central to our supervisory approach. We shall no longer intervene based solely on observable facts but will be proactively analysing risks at an individual firm level, making judgements about the prudential and conduct risks firms and consumers may face through, for example, high-risk lending strategies. We will intervene where necessary.

We also recognise that consumers are not always able to protect their own interests and therefore propose to rely less on disclosure and to intervene where necessary to curb sales of high-risk products, or sales to particularly vulnerable borrowers, or both. This will mean targeted product regulation, where appropriate, and a clear responsibility on lenders to assess affordability. To complement this more intrusive and intensive approach, we shall continue to pursue an aggressive and proactive approach to monitoring and enforcement.

Overall, the package of proposals discussed in this paper represents a very significant shift in the FSA's strategic direction. We are not seeking to pre-empt the outcomes of the debate: the aim is to stimulate a wide-ranging discussion. What matters is that collectively we deliver the right outcomes for the market. But where we are confident in our position and where we gain support, we intend to move quickly.

Acronyms

ACPO	Association of Chief Police Officers
APER	Statements of Principle and Codes of Practice for Approved Persons
BoE	Bank of England
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BTL	Buy-to-let mortgage
CAB	Citizens Advice Bureau
CBA	Cost Benefit Analysis
CCD	Consumer Credit Directive
CCJ	County Court Judgement
CDS	Credit Default Swaps
CML	Council of Mortgage Lenders
COBS	Conduct of Business sourcebook
CRA	Credit Ratings Agency
DCLG	Department for Communities and Local Government
DTI	Debt-to-Income (ratio or multiple)
DWP	Department of Work and Pensions
ERC	Early Repayment Charge
ESIS	European Standardised Information Sheet
FIT	The Fit and Proper test for Approved Persons
FOS	Financial Ombudsman Service
FSMA	Financial Services and Markets Act 2000
GDP	Gross Domestic Product

HMRC	Her Majesty's Revenue and Customs
ICOBS	Insurance: Conduct of Business sourcebook
IRB	Internal Ratings Based (models)
IVA	Individual Voluntary Agreement
IFRS	International Financial Reporting Standards
IRB	International Ratings Board
KFI	Key Facts Illustration
LTI	Loan-to-Income (ratio)
LTV	Loan-to-Value (ratio)
MCCB	Mortgage Code Compliance Board
MCOB	Mortgages and Home Finance: Conduct of Business sourcebook
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
MLAR	Mortgage Lending and Administration Return
NIV	Non-Income Verified
NSA	Not seasonally adjusted (data)
ODPM	Office of the Deputy Prime Minister
OFT	Office of Fair Trading
ONS	Office of National Statistics
PBR	Principles-Based Regulation
PRS	Private Rental Sector
PSB	Professional Standards Board
PSD	Product Sales Data
RAO	Regulated Activities Order
RDR	Retail Distribution Review
RMS	Regulated Mortgage Survey
SBS	5% Sample Survey of Building Society Mortgages
SA	Seasonally adjusted (data)
SML	Survey of Mortgage Lenders
SUP	Supervision manual
T & C	Training and Competence requirements

1 Overview

Introduction

- 1.1 In this Discussion Paper (DP) we set out the case for regulatory reform of the mortgage market. We discuss a number of the issues and causal drivers we believe have resulted in consumer detriment in the market, and options for addressing them. It is aimed at everyone involved in this market – consumers, consumer groups, investors, intermediaries, lenders and trade bodies – all of whom we hope will engage actively in this debate.

Our aims for the mortgage market

- 1.2 There are two broad aims of our review. The first is to have a mortgage market that is sustainable for all participants. This means:
- lenders have sustainable business models which are adequately capitalised, while at the same time remain competitive, innovative and competent at what they do;
 - a regulatory regime that is predictable, clear and transparent – where regulation is not a source of volatility and minimises the pro-cyclical impacts on house prices, while helping to minimise mortgage fraud and other forms of financial crime; and
 - where the costs and risks of lending and borrowing are kept within the market and are not borne by wider society.
- 1.3 The second broad aim is to have a flexible market that works better for consumers. This means that:
- it offers a range of products that meet the needs of different consumer types to allow individuals, who can afford it, the opportunity to buy their own home;
 - it is one where consumers clearly understand the costs and risks of mortgage borrowing;
 - consumers understand the implications and risks of considering property as an investment option rather than primarily as a home; and

- distribution helps to achieve good outcomes for consumers, and provides a professional service, with the number and complexity of products reflecting the needs of consumers, rather than firms, and where incentives in the distribution chain work for the consumer.

1.4 The DP sets out the issues we believe need to be tackled to achieve these outcomes and the options for addressing them. It is a comprehensive and detailed analysis of the issues in the mortgage market. We have taken into account the fundamental prudential reform already underway and developments under *The Turner Review*, including feedback on the Discussion Paper: we recognise the need to be sensitive to the macroeconomic backdrop to our reforms. We have also drawn on the lessons we can learn from the approach and experiences in other countries. The aim is to stimulate a wide-ranging discussion. The issues in the mortgage market are complex, spanning macroeconomics, financial stability, home ownership and consumer protection. It is important that we take the time to fully understand what went wrong and explore all of the available options for putting things right.

Structure of the DP

- 1.5 Our proposals are summarised in the following overview of the options for regulatory reform. The detailed analysis, including supporting data, follows in the main body of the DP. We ask a series of questions throughout the DP and we hope all stakeholders will respond to these and help inform the debate and shape and refine the proposals.
- 1.6 Annex 1 lists the DP questions and Annex 2 sets out our initial thoughts on the costs and benefits.
- 1.7 We have also undertaken a comprehensive statistical analysis of the market to help inform our work and that analysis will be published separately during the discussion period.

Next steps

- 1.8 The discussion period ends on 30 January 2010. We intend to run roadshows and set up industry and consumer groups during the discussion period to share views and promote discussion of the main areas for debate.
- 1.9 We expect to issue a Feedback Statement in March 2010 and, depending on its content, follow that with a Consultation Paper (or papers). We shall be considering the optimum timetable for implementing our proposals, with the intention of moving quickly to consult where possible and where the proposals have support.

Overview of the options for regulatory reform

Chapter 2: Macroeconomic background (page 17)

- 1.10 Homeownership and mortgage credit play a vital role in individual lives, in the financial system and in the macroeconomy. Residential mortgage debt in the UK amounts to around £1.23trillion, accounting for approximately 70% of all credit extended by lenders in the UK.
- 1.11 The wider macroeconomic background has been a key factor in the growth of the UK mortgage market. The origins of the crisis have been discussed at length in both the 2009 Financial Risk Outlook and *The Turner Review* and are the focus of renewed attention given the very recent publication of the Feedback Statement on *The Turner Review* Discussion Paper. It forms an important backdrop to our discussion on the options for reform.
- 1.12 Many households benefited from the benign economic environment and readily available cheap credit that emerged from the growth of global liquidity and fall in real risk-free interest rates. A lot of people now own their own homes (many of them outright) when previous generations would never have been able to do so. They will consider that they have been well served by the mortgage market in the UK.
- 1.13 However, as we shall see, the abundance of liquidity in the UK mortgage market led to financial innovation and increasing levels of risk being taken on by banks through relaxing credit standards and lending to individuals who had previously been excluded from the mortgage market. Cheap credit meant that consumers were willing to take on ever increasing amounts of debt. Many of those consumers exposed themselves to high levels of debt relative to their disposable income and are experiencing financial difficulties as a result. The number of arrears and repossessions has been continuing to increase and is forecast to continue rising over the next year.
- 1.14 Some of the drivers of the market growth are outside the FSA's regulatory scope. Monetary and fiscal policy will remain part of the background against which we and firms operate. Regulation alone will therefore be unable to resolve the problems in the UK mortgage market, cannot reverse the impact of the downturn and can only go so far in ensuring that the unsustainable and destabilising boom in the property market is not repeated in the next upswing. And this review does not consider the issue of whether variations in product specific requirements (for example, maximum permissible loan-to-value or loan-to-income ratios) might ever form part of a discretionary macro-prudential regime.
- 1.15 Although the downturn and pressure to reduce overall levels of debt has led to a sharp reversal in firms' attitude to risk management, there is a risk that, as the economic cycle turns, some of the practices and growth experienced before 2007 will re-emerge if not controlled. Our existing regulatory framework has been shown to be ineffective in constraining irresponsible high-risk lending and borrowing and there is a general consensus that substantial regulatory policy reform is needed to reduce the probability and dampen the severity of future financial crises.

- 1.16 Chapter 3 considers the prudential reform and Chapter 4 the conduct of business reforms that we believe will deliver a regulatory regime fit for the future.

Chapter 3: Prudential reforms (page 23)

Impact of overall capital and liquidity reforms on the mortgage market (page 23)

- 1.17 Prudential levers are critical to the shape of our overall reform package. There is a need to reduce the underlying incentives and ability of lenders to supply limitless credit with relatively few checks.
- 1.18 We explain the fundamental reform of the FSA's prudential policy framework currently underway and discuss the likely impact of that reform on the mortgage market. The most significant developments relate to new quantitative liquidity standards and the application of a new stress test-based approach to capital adequacy.
- 1.19 *The Turner Review* has also proposed a large range of prudential policy changes, including the call for both higher quality and a higher quantity of minimum capital, a gross leverage ratio and a counter-cyclical capital framework. We expect that these developments will significantly increase the amount and quality of capital that banks and building societies maintain for their mortgage lending, which could go some way to address the issue of irresponsible lending. There are also likely to be wider effects on banks' assessment of risk through the economic cycle and the ability and willingness to expand lending rapidly during a boom phase.
- 1.20 Prudential reforms which will affect the mortgage market are also driven by various proposals put forward by the European Commission, for example those which aim to regulate various aspects of securitisation as a funding mechanism for lenders.
- 1.21 Alongside the overall rules on capital and liquidity, the dynamics of the mortgage market are affected by whether our capital regime adequately differentiates between the riskiness of different categories of loan. Our analysis of ten of the largest lenders confirms that high-risk products (as measured by LTV ratio) do indeed attract more capital. We believe this, together with the overall reforms to the capital and liquidity regimes, will largely address the problem of rapid credit expansion and then withdrawal, and therefore conclude that there is no need, at this stage, to propose additional prudential measures specific to mortgages.

Prudential vs. conduct of business levers (page 30)

- 1.22 To minimise the risk of overlapping regulations, we have considered carefully whether the fundamental changes in prudential policy would of themselves be sufficient to constrain irresponsible lending, whether we could increase capital (over and above prudential requirements) to constrain high-risk lending or whether there is a need to enhance the conduct of business side. Our analysis suggests that increasing capital requirements would not be an effective mechanism for deterring high-risk lending and that using prudential levers to achieve objectives relating to consumer detriment is subject to significant uncertainty. We explain this and the need for reform on the conduct of business side.

High-risk lenders (page 32)

- 1.23 We do think there is a case, though, for using prudential levers for reasons other than financial stability and depositor protection. This has arisen in the context of our proposals for reforming the prudential regulation of high-risk lenders, which includes non deposit-taking lenders ('non-banks'). We have seen that non-banks, in particular, can easily enter the market in an upswing and exit in a downswing, and thus exacerbate the pro-cyclicality of the market. We therefore discuss whether there is a case for regulatory proposals specific to high-risk lenders.

Chapter 4: Conduct of Business reforms (page 36)

Product regulation (page 36)

- 1.24 The FSA has in the past been reluctant to embrace the idea that it should regulate products on the grounds that this might inhibit innovation. However, *The Turner Review* raised the question of whether the historical approach of ensuring full disclosure of risks failed to recognise that there are some products where the risks of detriment to consumers and firms manifestly outweigh the potential benefits and this justifies intervention by the regulator. The DP continues this debate and considers whether we should be banning certain products.

Loan-to-value (LTV) loan-to-income (LTI) or debt-to-income (DTI) ratios (page 37)

- 1.25 A question that has generated considerable debate already is whether we should cap loan-to-value (LTV) or loan-to-income (LTI) ratios. We have also considered the case for specifying debt-to-income (DTI) ratios. We already use LTV thresholds for prudential purposes. These thresholds are not hard limits beyond which no lending can occur, but are used to set capital requirements which rise as the LTV increases. This is because LTV remains an important indicator of risks to a firm. However, our analysis suggests that the case for imposing any of these ratios on consumer protection grounds is not clearly proven.
- 1.26 We do not, however, rule out the application of LTV, LTI or DTI caps in future as tools that could be employed as part of a wider counter-cyclical macro-prudential framework (a discussion which is out of the scope of this Review) or, in the light of further analysis of the pattern of arrears and repossessions as the current downturn continues. Capping ratios is a blunt approach to achieving the outcomes we want. It could also lead to a reduction in access to credit for some people able to afford high LTVs but not having access to the means (such as parental support) by which others may afford higher deposits. There are some products, however, where we believe the case for banning them is much clearer.

Prohibiting loans to borrowers exhibiting certain multiple high-risk characteristics (page 45)

- 1.27 Our analysis suggests that high-risk features such as high LTV or LTI ratios may not of themselves pose any significant risk to consumers. However, coupled with the fact that an increasing proportion of such lending was to riskier credit groups with lower income levels and higher levels of debt, there was an increase in risks both to the consumer and the firm. We therefore discuss whether a type of product regulation likely to be more effective in protecting consumers would be to prohibit loans that are a mix of high-risk factors, for example, prohibiting high LTV loans to credit-impaired borrowers who have an unstable income or other similar ‘toxic’ mixes.

Non-income verified mortgages (page 47)

- 1.28 In our view, there is a clear and non-controversial case for product regulation of non-income verified (self-certified or ‘self-cert’ and fast track) mortgages. Self-cert mortgages were designed by the market to meet the needs of self-employed borrowers but grew way beyond the consumer groups for which they were originally intended. Our analysis shows that self-cert borrowers take out larger loan amounts than borrowers with standard products and fall into arrears much more frequently. To address these issues, we propose to require verification of income for all mortgage applications.

Sales regulation (page 50)

Affordability assessments (page 50)

- 1.29 In our view, a key problem has been the lack of proper affordability assessments. Over several years, our various thematic reviews of mortgage lenders and intermediaries have found evidence of irresponsible lending practices and inadequate affordability assessments. We believe that there is significant scope to tighten our responsible lending standards.
- 1.30 We propose making the lender ultimately responsible in every sale for verifying affordability. We also propose that in each case, lenders assess consumers’ borrowing capacity based on free disposable income. As a way of promoting debate around this issue, we have included in the DP an example of current industry best practice for assessing affordability. We also discuss whether we should prohibit lending to consumers with low borrowing capacity; whether there is a case for assessing the affordability of an interest-only mortgage on a capital repayment basis; and also whether there is a need to limit the amount of equity a consumer can take from their home.

Chapter 5: Distribution and advice (page 59)

- 1.31 The focus of our proposals for constraining irresponsible lending is on lenders. It is the lenders who create and sell the products. But the intermediary distribution channel has become a very significant part of this market and we have also considered whether there is a need to reform our approach to regulating mortgage intermediaries.

Advice and selling standards (page 61)

- 1.32 Our analysis shows that consumers do not understand the distinction between advised and non-advised (information-only) sales and we have considered whether there is a case for removing that distinction. 30% of all mortgage sales are non-advised and our view is that we should retain non-advised sales but introduce a standardised affordability and appropriateness check across all sales.
- 1.33 We believe that this approach would address the most significant area of consumer detriment within the current non-advised process, in that firms will no longer be able to provide the consumer with information on a range of mortgages without first assessing whether a mortgage is actually appropriate or affordable for that consumer.
- 1.34 For those sales where the firm recommends a particular product to a consumer, we propose that the existing prescriptive suitability checks will continue to apply, though we consider whether there is a case to tighten those standards. Given that we are making the lender ultimately responsible for affordability checks, we also discuss the requirements on intermediaries to assess affordability.

Extending the Approved Persons regime (page 65)

- 1.35 There are certain functions ('Controlled Functions') within a firm that we consider to be of sufficient importance that the individuals carrying out those functions need to be 'Approved Persons', that is assessed by us as 'fit and proper' before they can carry them out. After that, an Approved Person must continue to comply with the Fit and Proper test for Approved Persons and the Statements of Principle for Approved Persons.
- 1.36 Controlled Functions are those jobs or responsibilities within a business that have a particular regulatory significance. Currently for mortgage and other home finance firms the only relevant Controlled Functions are some of the 'significant influence' functions i.e. those individuals who exercise significant influence over the firm. We are including in the DP a proposal to extend the Approved Persons regime to mortgage advisers and/or arrangers who deal with consumers ('consumer-facing' functions) and to those advisers and/or arrangers who are responsible for overseeing compliance ('compliance oversight' functions).
- 1.37 We see several possible benefits from applying the consumer and compliance oversight functions to mortgage intermediaries that may mitigate risks to our consumer protection and financial crime objectives. These include improving standards of fitness and propriety among individual mortgage advisers and prohibiting rogue individuals from the industry. Such a regime would also enable the FSA to impose the full range of disciplinary sanctions on individual advisers to help raise standards.

Retail Distribution Review (RDR) read-across (page 67)

- 1.38 We noted in the Retail Distribution Review (RDR) Feedback Statement (December 2008) that we were undertaking a thorough review of our mortgage regime and that our analysis so far had not identified a need to apply an RDR approach to mortgage distribution. We said we would keep this under review pending further analysis.

- 1.39 Our further work has not suggested a need to apply to the mortgage market the constraints on adviser charging which the RDR requires in relation to investment advice – but we do see merit in aligning with the RDR approach in a number of other areas. We believe that our current regulatory landscape for mortgage distribution is overly and unnecessarily complex and our scope of service labels (‘whole of market’, ‘tied’, ‘single’) are not enhancing consumer understanding of a firm’s service. We think that aligning with the RDR labels (‘independent’ [whole of market] and ‘restricted’ [limited]) makes sense and will be less confusing for consumers.
- 1.40 We also see merit in reading across elements of the RDR professional standards work. We do not see a case for requiring an improvement in qualification standards in the mortgage market but do see merit in applying a code of ethics.

Chapter 6: Disclosure and changing consumer behaviour (page 72)

- 1.41 We believe that irresponsible borrowing has been just as much a part of the problem in the mortgage market as irresponsible behaviour by firms. Most consumers, of course, have acted responsibly, but a significant minority have made decisions which were imprudent and which they should have been in a position to recognise as such in advance. We consider the extent to which the fact that a mortgage consumer is focused on the end result, such as the home, holiday or car, makes them less cautious about the mortgage, the means by which they get these. Our policy approach to date has been underpinned by a view that mortgage consumers will act rationally to protect their own interests. We believe that we need to change that approach, recognise the behavioural biases of consumers and be more interventionist to help protect consumers from themselves.

Reform of disclosure (page 72)

- 1.42 Our approach to consumer responsibility to date has relied on consumers being motivated to protect their own interests. Disclosure is the cornerstone of the current mortgage regime, designed to enable consumers to shop around and compare the services and products on offer from different firms and help them make informed choices. But, as we explain, the evidence shows that many consumers do not use disclosure as intended.
- 1.43 We therefore propose to change our approach and align more closely with that taken in both the investment and insurance markets, where we have moved to a position where the focus is on early disclosure of key service information rather than the prescription of the form of that information. For example, we know that firms typically provide terms of business disclosure, usually in letter form. Being both personalised and ‘free text’ this could well be a better means of disclosing fees information and information about the level of service on offer than the Initial Disclosure Document.
- 1.44 Alongside this we are considering whether to require supplementing this written information by oral disclosure. Oral disclosure might also be an option to support the existing product (Key Facts Illustration) disclosure, which we believe we should retain. But overall, we think that our regulatory strategy needs to change to one that relies less on disclosure as a regulatory tool and looks to influence consumer behaviour in a more sophisticated way.

Changing consumer behaviour (page 73)

- 1.45 We signal here a greater realism about the behavioural biases that drive excess borrowing and a willingness to be more interventionist to help protect consumers from themselves (for example, through banning products or prohibiting sales to those consumers exhibiting multiple high-risk characteristics or limiting the amount of equity that can be withdrawn).

Financial capability (page 75)

- 1.46 We have also considered how financial capability initiatives may help (for example, by re-educating consumers away from the idea that renting is bad and home ownership good, and away from seeing property as an investment).

Chapter 7: Arrears and Repossessions (page 78)

- 1.47 We discuss the work already underway in response to the outcomes of our thematic review of the arrears management practices of firms. This includes the enforcement action against some firms, and our proposed consultation in January 2010 on strengthening our conduct of business rules on arrears handling and on prohibiting firms from imposing arrears charges on those borrowers who have an agreed arrangement in place. We have also signalled that we shall be reviewing the relationship between lenders and third-party administrators.

Chapter 8: Unfair charging practices and price regulation (page 82)

- 1.48 In this chapter, we have signalled our appetite to more rigorously monitor and enforce our existing charging rules. We explain the work already underway to establish in-house expertise in this area which will help us develop a better understanding of firms' charging practices and pricing structures. This will enable us to identify and challenge unfair, excessive and/or exploitative practices. We also indicate that we shall be assessing the case for prohibiting certain specific charges generally, in addition to the arrears charges, noted above.
- 1.49 This marks a substantial change in our approach to date. As with product regulation, the FSA has been reluctant in the past to be a price regulator. Although we have mortgage rules in place that prohibit excessive charging generally, we have in practice preferred to rely on disclosure and transparency of charges and consumers protecting their own interests. However, our analysis suggests that many consumers lack the desire and ability to compare charges and focus exclusively on the headline interest rate instead. So firms have a degree of market power in setting charges and have not been subject to adequate competitive constraints.

Chapter 9: Scope extensions (page 84)

- 1.50 Although the decision is one for the government, we set out in this chapter why we think there is a case for extending FSA regulation to consumers taking out second and subsequent charge mortgages and to borrowing for buy-to-let.

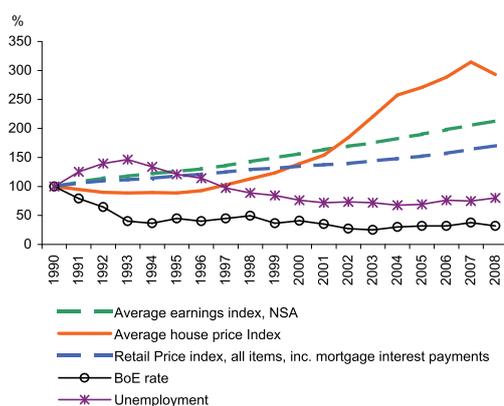
Chapter 10: Other matters for discussion: (page 90)

- 1.51 **Sales of mortgage books:** the government's proposal to consult on extending FSA regulation to those unauthorised firms buying-up regulated mortgage books (page 90);
- 1.52 Proposals for enhancing our **reporting requirements** (page 90);
- 1.53 The way in which our proposals support our **financial crime and mortgage fraud prevention** objectives (page 94);
- 1.54 The impact of our proposals on **equity release** (page 96); and **Right-to-Buy** (page 97).
- 1.55 **EU policy dependencies:** the possibility of the European Commission announcing policy initiatives affecting both mortgages and credit intermediaries (page 100);

2 Macroeconomic background

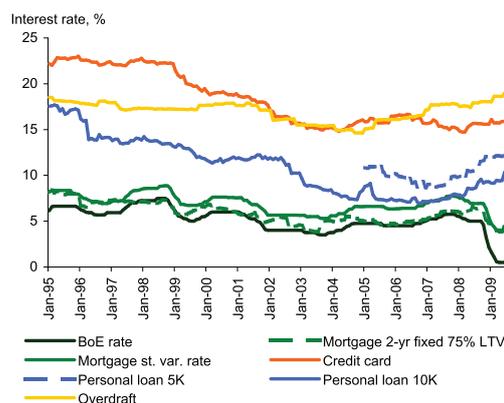
2.1 Earlier this year – in our 2009 *Financial Risk Outlook* and *The Turner Review* – we set out our view on the causes of the current global financial crisis.¹ Global macro-imbalances produced rapid growth of global liquidity and a fall in real risk-free interest rates. This contributed to a lengthy period of benign economic conditions in the UK.

Exhibit 2.1:
Average annual house prices and other economic indicators
(Baseline: 1990 = 100%)



Source: Nationwide, ONS, BoE, FSA calculation

Exhibit 2.2:
Price of credit, by type



Source: BoE

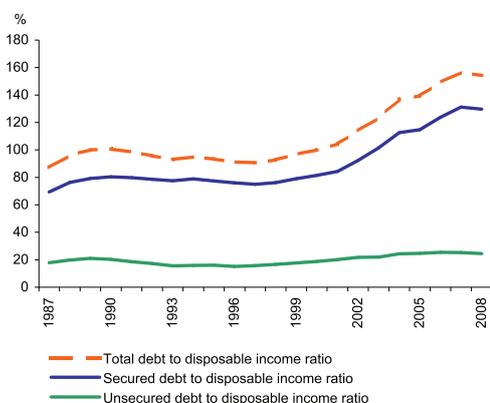
2.2 This resulted in developments in the housing and mortgage markets that played a significant role in the crisis in the UK. As exhibit 2.1 indicates, benign economic conditions provided the background of low unemployment, high economic activity (which boosted earnings) and low interest rates. This allowed many households to take on increased levels of personal debt, both secured and unsecured. The historically low interest rate environment made mortgage debt a relatively cheap form of debt for many homeowners (exhibit 2.2). The different levels of credit risk were often not reflected in the interest rate differentials.² As a result of this, borrowers were allowed to extend their debt levels beyond previous levels (exhibit 2.3).

1 FSA (2009) *The Turner Review*; www.fsa.gov.uk/pubs/other/turner_review.pdf; FSA (2009), *Financial Risk Outlook*, section B; www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2009.pdf

2 Bank of England (2009), *Trends in Lending 2009*, p.11

Exhibit 2.3:

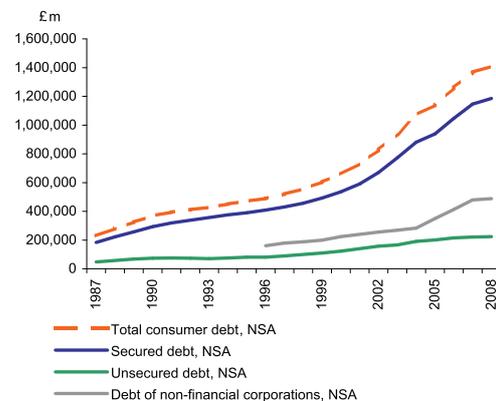
Secured and unsecured debt to disposable income ratios



Source: ONS

Exhibit 2.4:

Outstanding secured and unsecured debt of households and non-financial corporations

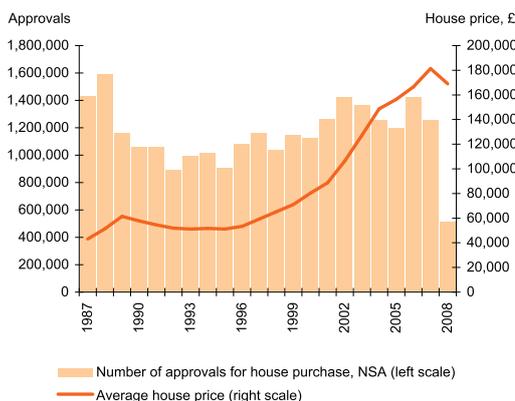


Source: ONS, BoE

- 2.3 Residential mortgage debt³ in the UK now amounts to around £1.23trillion, accounting for approximately 70% of all credit extended by lenders in the UK (exhibit 2.4).
- 2.4 The rapid growth of mortgage credit drove a house price boom which, in turn, continued to drive the demand for mortgage credit (exhibit 2.5). Continued house price appreciation led consumers to believe in the value of investing in property to achieve long and short-term goals. It appeared to be a one-way bet. Consumers wanted to get on the property ladder and benefit from the capital appreciation; some of those on the property ladder wanted to invest in other properties; many borrowed against the capital appreciation in their homes, dipping into the wealth in their property to sustain their consumption levels or repay debts.
- 2.5 As exhibit 2.6 illustrates, deposits alone could not fund the demand from households and businesses for credit and we saw lenders change their funding strategies away from reliance on customer deposits to an aggressive use of and increasing reliance on, wholesale funding enabling them to rapidly increase market share.

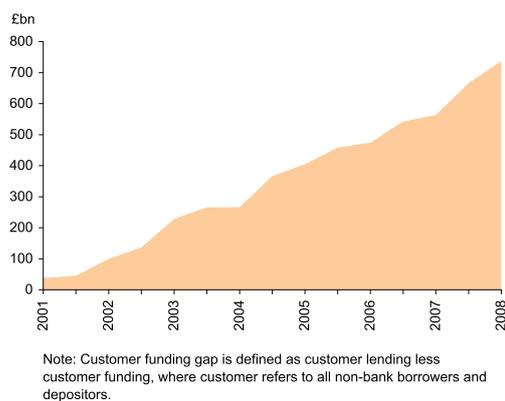
³ August 2009 BoE data not seasonally adjusted. This is outstanding lending secured on dwelling (i.e. owner occupied and buy-to-let)

Exhibit 2.5:
Mortgage approvals and house prices



Source: BoE, Nationwide

Exhibit 2.6:
Major UK banks' customer funding gap

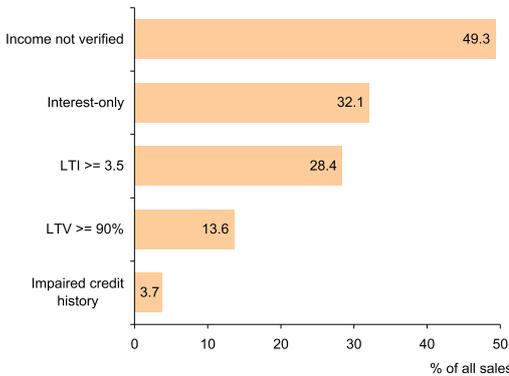


Sources: BoE, Dealogic, ONS, published accounts and BoE calculations

- 2.6 Just as continued house price appreciation led to an irrational exuberance on the part of some borrowers, some lenders also assumed that debt burdens were likely to fall with continuous property price appreciation and made lending decisions based to a significant extent on the underlying collateral without undertaking a proper assessment of the consumer's ability to repay the sums lent. There was an explosion in the number of mortgage products available to meet the demand. Credit standards were relaxed and mortgage credit was extended to social categories that could not previously have qualified. As exhibit 2.7 illustrates, high-risk loans came to account for a significant share of the total market.
- 2.7 The transfer of risk through whole loans sales and/or securitisation also contributed towards the relaxation of lending standards. The traditional mortgage funding model involving a bank using savers' deposits to originate a loan to a borrower and retaining the credit risk on its books was increasingly combined with securitisation and whole loan sales as a means of funding. This method of funding did not in itself pose a problem, but many cases involved the 'originate to distribute' model, in which credit risk was no longer retained on a lender's books but transferred to investors. As risk was not retained on the lender's balance sheet, less care needed to be taken about the quality of the lending and underwriting standards were relaxed and lending quality suffered.
- 2.8 Although securitised forms of credit intermediation had been growing since the 1970s, especially in the US, the growth in the total value of credit securities exploded in the late 1990s in both the US and the UK (exhibit 2.8). By the end of 2007, the total amount of outstanding credit securities in the UK had grown to £180 billion, a nine-fold increase compared to 2000.

Exhibit 2.7:

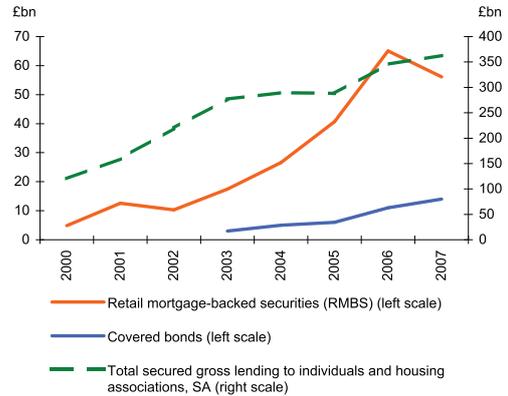
Share of all regulated mortgage sales represented by high-risk products in 2007



Source: FSA PSD

Exhibit 2.8:

Secured gross lending and securitisation issuance in period, UK

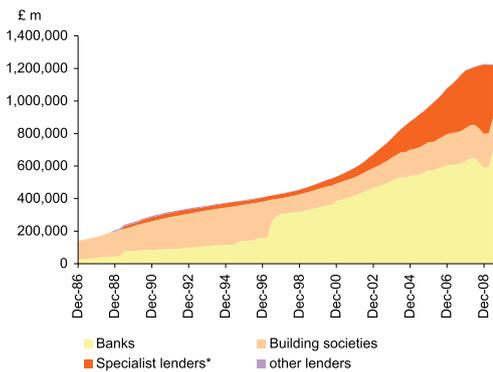


Source: Oliver Wyman, BoE

2.9 This period also saw the emergence of specialist, ‘non-bank’ lenders, competing aggressively in the market. Their market share for residential lending (i.e. excluding buy-to-let) increased from 4% in 2000 to a high of approximately 15% in 2008 (exhibit 2.9). These non-bank lenders do not have a high-street presence, sell mortgages exclusively through intermediaries, and do not rely on depositors to fund their operations. Instead, they use securitisation and other forms of wholesale funding, such as whole loan book sales, which made it easy for them to enter the UK market and rapidly grow in the upswing – and exit equally easily and rapidly in the downswing.

Exhibit 2.9:

Quarterly amount outstanding of net secured lending to individuals and housing associations, by type of lender

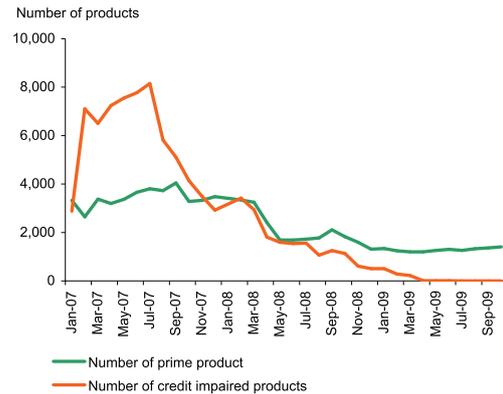


* Approximately half of net secured lending is attributable to non-banks

Source: BoE

Exhibit 2.10:

Number of residential mortgage products

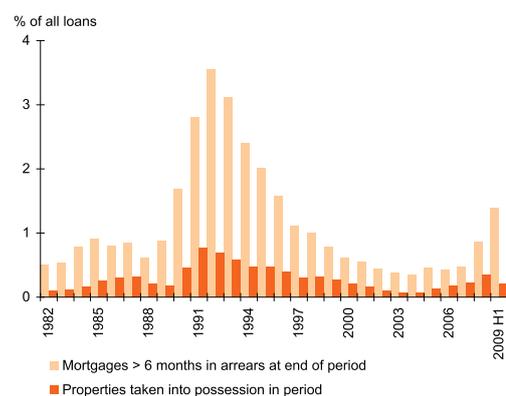


Source: Moneyfacts

2.10 Given the saturation of the mainstream market and the ready availability of cheap funding, the non-banks rapid credit expansion was primarily into new, high-risk consumer segments that previously had only limited access to mortgages.

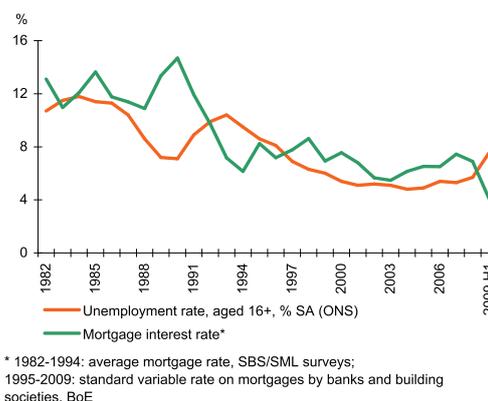
- 2.11 We also saw the emergence of business models built specifically around consumers with impaired credit histories but with equity in their properties (equity lending). Sustained house price growth meant there appeared to be less risk of a loss on sale and as a result, the consumer's propensity to default appeared a less important lending risk to consider. So, the fact that consumers might not be able to repay came to be considered less relevant to these firms. Indeed, they entered the market with the expectation that a large number of their consumers would not be able to pay and would either have to remortgage or face repossession.
- 2.12 Booming property prices made the lower credit standards appear costless for some considerable time but, in the end, they proved unsustainable. The new sources of funding rapidly dried up when confidence disappeared in the wake of the problems in US 'subprime' lending. The proliferation of risky lending practices and lending to uncreditworthy consumers helped to undermine confidence. There was a massive contraction in the market (exhibit 2.10). Mortgage credit availability rapidly declined and house prices fell significantly.
- 2.13 Worsening economic conditions have now produced a significant rise in arrears and repossessions (exhibit 2.11).

Exhibit 2.11:
Arrears and repossessions on 1st charge mortgages (owner occupier and BTL)



Source: CML

Exhibit 2.12:
Mortgage interest rate and unemployment



* 1982-1994: average mortgage rate, SBS/SML surveys;
 1995-2009: standard variable rate on mortgages by banks and building societies, BoE

Source: ONS, SBS/SML, FSA PSD

- 2.14 It is not yet clear how the eventual scale of arrears and repossessions in this recession will compare with those observed in the last major recession and period of house price falls, in 1989-92. It is possible that total numbers will be less than in the 1990s, as a result of the very different pattern of interest rates. Between 1988 and 1990 typical mortgage rates rose from 11% to 15%, average rates have fallen in this recession, and typical Standard Variable Rates, at around 4% are now at the lowest level for at least 50 years (exhibit 2.12). It is therefore much less likely that people who remain in employment will have difficulties meeting mortgage payments.

- 2.15 The impact of rising unemployment, however, may still drive significant further increases in both arrears and repossessions. And whatever the aggregate picture, there is, as Chapter 3 will describe, a pronounced tail of consumers who have taken on unsustainable mortgages and amongst whom arrears problems are now strongly concentrated.
- 2.16 The problems of the mortgage market can therefore be summed up as:
- A general across-the-market problem of rapid credit expansion and then withdrawal has made the overall economy volatile and will probably lead to significant credit losses, even if not necessarily as bad as in 1989-94; and
 - A significant tail of very poor lending decisions, reflecting the extension of credit to consumers whose capacity to afford it was always low, is now producing very high losses in particular categories of mortgage, which we discuss later in Chapter 3.
- 2.17 Some of the drivers of the unsustainable growth we saw in the mortgage market are outside the FSA's regulatory scope. Monetary and fiscal policy will remain part of the background against which the FSA and firms operate. Regulation alone will therefore be unable to resolve all the problems in the UK mortgage market and can only go so far in ensuring that the unsustainable and destabilising boom in the property market is not repeated in the next upswing.
- 2.18 However, our existing regulatory framework has been shown to be ineffective in constraining irresponsible high-risk lending and borrowing, and there is a general consensus that substantial regulatory reform is needed to reduce the probability and severity of future financial crises.
- 2.19 Chapter 4 discusses possible changes to our conduct of business requirements to address issues of irresponsible lending. The following chapter discusses the prudential reforms underway or proposed that could help address issues of credit market and financial stability.

3 Prudential reform

Impact of overall capital and liquidity reforms on the mortgage market

- 3.1 Our prudential policy framework is currently undergoing fundamental reform. The most significant developments already underway are new quantitative liquidity standards and the application of a new stress test-based approach to capital adequacy, first developed for the major banks. Further changes, in particular to the capital regime, were proposed in *The Turner Review* and the accompanying Discussion Paper. These proposals are substantially in accord with regulatory developments at the international level and a significantly strengthened global capital regime is currently being developed by the Basel Committee on Banking Supervision (BCBS) and in co-operation with the international Financial Stability Board. Prudential reforms which will affect the mortgage market are also driven by various proposals put forward by the European Commission, for example those which aim to regulate various aspects of securitisation as a funding mechanism for lenders.
- 3.2 In aggregate, these changes to the overall prudential framework for the banking sector will have a very major impact on the UK mortgage market, and we see no need at this stage to propose additional prudential measures specific to mortgage lending.

Our liquidity policy

- 3.3 The quantitative liquidity standards set out in PS09/16 will affect the liability profile and asset composition of all banks and building societies.⁴ By incentivising firms to reduce their reliance on short-term wholesale funding, the new liquidity policy is likely to increase the average costs of funding for all lending, including mortgages. At this stage we do not have an analysis which would allow any estimate of the size of the impact of liquidity policy on the price of mortgage lending in particular.⁵ However the cost of mortgages is also likely to be considerably less volatile through the cycle.

4 FSA (2008), *Strengthening liquidity standards: including feedback on*, CP08/22; CP09/13, CP09/14.

5 FSA (2008), CP08/22 Strengthening liquidity standards, www.fsa.gov.uk/pages/Library/Policy/CP/2008/08_22.shtml.

To the extent that mortgages are held on lenders' balance sheets, these measures will help ensure that banks and building societies maintain adequate levels of liquidity, the supply of lending is sustainable and market volatility is decreased.

- 3.4 In the years leading up to summer 2007, firms could readily access funding in the wholesale markets, and sought to maximise the benefits by relying on short-term funding, increasing the mis-match between their liability profile and the maturity of their assets. Following the onset of the financial turmoil, funding availability declined rapidly and spreads increased sharply – with consequent impacts on firms' ability to lend to mortgage borrowers, as well as the cost of lending. If our new standards on liquidity had been in place, bank lending would not have increased as rapidly during the upswing, nor been cut so dramatically in the downswing.
- 3.5 Firms would have faced strong disincentives not to become so reliant on short-term funding during the boom phase of the cycle and they would therefore have been less vulnerable to the subsequent liquidity crunch. This should have reduced both the overall magnitude of the liquidity crunch that occurred, and its impact on firms' willingness to continue to provide lending through the downturn.⁶

Stress-testing and the interim capital regime

- 3.6 The recapitalisation of some of the major UK banks in October 2008 was based on a stress test, with the firms required to meet and maintain core Tier 1 capital of at least 4% of their Risk Weighted Assets even in the face of a severe downside scenario. This approach, which is applied to a set of financial institutions including the largest UK building society and banks, represents a significant strengthening of the capital requirements which we impose.
- 3.7 This framework will remain in place until the Basel II Accord – which is implemented through the EU Capital Requirement Directive (CRD) has been modified to reflect the lessons learned from recent events. A similar approach was adopted for building societies who applied for the Credit Guarantee Scheme (CGS) in Q4 2008, requiring them to be able to maintain a Tier 1 capital ratio of 7% after stress effects.⁷
- 3.8 Over the months since the intensification of the financial crisis in autumn 2008 we have:
 - greatly increased the use of stress tests as an integral element of our ongoing supervisory approach;
 - begun the process of embedding this revised approach in our intensive supervisory regime; and
 - used stress tests to inform policy decisions such as access to the Credit Guarantee Scheme (CGS) and the Asset Protection Scheme (APS), working closely with the other Tripartite Authorities.

6 Of course, to a significant extent funding has been provided to banks and building societies through the Bank of England's Special Liquidity Scheme. So one key impact of the liquidity policy would be to reduce firms' reliance on central bank liquidity support during financial stress.

7 FSA (2009) *Statement on regulatory approach to bank capital*, www.fsa.gov.uk/pages/Library/Communication/Statements/2009/bank_capital_.shtml

- 3.9 The specific stress test parameters will change over time, but stress-testing will be part of our ongoing prudential approach. Key elements of the test currently being applied are as follows:⁸
- the current stress scenario models a recession more severe and more prolonged than those which the UK suffered in the 1980s and 1990s;
 - it assumes a peak-to-trough fall in GDP of over 6%, with growth not returning until 2011 and only returning to trend growth rate in 2012;
 - it models the impact of unemployment rising to just over 12% and, crucially, the effect of a 50% peak-to-trough fall in house prices and a 60% peak-to-trough fall in commercial property prices.
- 3.10 The consequence of embedding the stress-testing approach in our supervisory regime is that the possibility of banks and building societies holding insufficient capital against the credit risk in their mortgage lending will be substantially lower than in the past. Because these firms will have to hold capital against a stressed economic scenario, the impact of future buoyant economic and financial market conditions on their ability to rapidly expand lending will be reduced. Required capital should be more stable through the economic cycle, as well as higher on average.

The Turner Review and the future prudential regulatory framework

- 3.11 *The Turner Review* proposed a large range of prudential policy changes and many of these will affect banks and building societies engaged in mortgage lending. The key policy proposals which should affect these firms are:
- the call for both higher quality and a higher quantity of minimum capital;
 - measures to reduce pro-cyclicality in current regulatory capital and accounting frameworks;
 - a counter-cyclical capital framework; and
 - a gross leverage ratio.

Higher quality and a higher quantity of minimum capital

- 3.12 *The Turner Review* argues that, for systemically significant banks, there is little or no role for lower quality capital which absorbs losses only on a gone concern basis, for example, dated subordinated debt. In addition, we expect the current debate in the BCBS working group on the definition of capital to result in a more harmonised and more robust definition of high quality (core Tier 1) capital, and we expect a higher level of such capital to be required. At present, under the CRD, it is at least in

8 FSA (2009), Press release on the FSA's use of stress tests; FSA/PN/068/2009, 28 May 2009

principle possible for a firm to hold as little as 2% core Tier 1 capital: the FSA's interim capital regime has effectively doubled this minimum to 4%, with further buffers required in addition to meet stress test requirements.

- 3.13 There is clear international agreement that the overall level and quality of regulatory capital should increase. Basel I imposed the requirement that a bank hold capital of at least 8% of its Risk Weighted Assets and this was carried over into Basel II. However, this minimum level was determined pragmatically – essentially by the desire not to allow a large reduction in the overall capital held in the banking system while also not forcing it to increase sharply. The BCBS and the international Financial Stability Board are committed to having a new capital regime agreed within 12 months which will mean that ‘the level and quality of minimum capital requirements will increase substantially over time.’⁹
- 3.14 While the details are therefore still to be determined, it is clear that capital requirements in aggregate will be higher. The effects will apply across banks' balance sheets and therefore should not have particular effects on the supply of mortgage loans relative to other loan classes. However, they will have higher absolute impacts on the capital required against high-risk loans – so if a high-risk mortgage has, for example, a risk weight three times higher than that for a prime mortgage with a modest loan-to-value ratio, then the absolute amount of additional capital required under the new regime will be three times larger for the high-risk loan.

Measures to reduce pro-cyclicality

- 3.15 One of the most significant agreed policy responses to the recent financial crisis is the commitment from regulators and many others to reform the Basel II framework to remove pro-cyclicality and put in place actively counter-cyclical policies. We have already taken steps to remove pro-cyclicality by encouraging firms with IRB models to move onto ‘variable scalars’.
- 3.16 Variable scalars are a way of reducing the cyclicality of the Probability of Default (PD) parameter, with the objective of distinguishing cyclical changes in PD from borrower-specific (idiosyncratic) changes and removing the impact of the cyclical changes. This has a large impact on the volatility of PDs through the economic cycle: the PD will fall less in an upswing and will increase less in a downturn. Variable scalars are therefore likely to reduce the risk that in a boom period banks underestimate the probability of default. Due to the relative abundance of data on mortgages, we have adopted this approach first for banks' mortgage portfolios.
- 3.17 In addition to smoothing minimum required capital, there are two other elements to the counter-cyclical capital framework. The first is a change to provisioning practices which currently are driven by the incurred loss model required by International Financial Reporting Standards (IFRS). In particular *The Turner Review* made the case for a dynamic reserve or provision which would reflect the expected loss on a loan portfolio over the cycle as a whole. A dynamic provisioning approach would force banks to

9 Improving Financial Regulation, report of the Financial Stability Board to G20 leaders, http://www.financialstabilityboard.org/publications/r_090925b.pdf

put aside reserves against future expected losses even if current incurred losses are very low. This should reduce the volatility in firms' capital resources by smoothing out the large losses that occur in a downturn over the cycle as a whole. Reforms to accounting practices which will go some way to achieving this are now being considered by the International Accounting Standards Board.

Introducing overt counter-cyclicality

- 3.18 In addition to the measures described above, *The Turner Review* argued for a capital buffer which would be available to absorb losses in a downturn and which firms would need to build up on top of minimum capital requirements in periods of upswing. Such a buffer would actively counter the tendency for banks to expand lending in boom periods only to contract as an economic downturn takes hold.
- 3.19 As with the other major reforms to prudential policy in *The Turner Review*, the counter-cyclical capital framework is not specific to mortgage lending. However, it will have significant impacts which are relevant to achieving the outcomes we want. It will help reduce the risk that an economic boom and associated low levels of currently observed default rates may encourage firms to expand lending rapidly because the likelihood of relatively short-term losses is low. In general, in an upturn banks will be required to be building up their capital buffer, or at least not reduce it. This should also have the effect of dampening excessive lending in a phase of strong growth, both by forcing more reserves to be held back for the anticipated downturn and through the signalling effects of regulators requiring capital buffers to be accumulated.

A gross leverage ratio

- 3.20 *The Turner Review* also proposed a gross leverage ratio and work on constructing such a ratio is now well underway in one of the BCBS working groups. A gross leverage ratio is more likely to constrain banks whose assets are perceived to be relatively low risk (but which may turn out, in a period of economic stress, to have high loss rates).
- 3.21 The leverage ratio acts as a limit on a firm's ability to grow its balance sheet excessively. For example, if a mortgage lender's business strategy was focused on strong growth during a period of rapid economic expansion a gross leverage ratio could help to limit the extent to which this 'model arbitrage' is possible by requiring a fixed minimum amount of capital per unit of exposure.

Q1: Do you agree that the prudential reforms will ensure that banks and building societies are adequately capitalised for the risks inherent in mortgage lending and should support a more stable mortgage market through the economic cycle?

EU proposals on the regulation of rating agencies and securitisation

- 3.22 The proposals set out above apply to mortgages held on lenders' balance sheets. However, as we saw in Chapter 1, a significant share of mortgages were securitised and thus no longer retained by lenders. Reforms relating to securitised credit origination, rating and distribution are therefore also relevant to the future possible dynamics of the mortgage market.
- 3.23 Three measures within the EU's currently planned legislative programme are likely to have an impact on the mortgage market through their implications for securitisation.
- 3.24 First, the European Regulation on Credit Rating Agencies (CRAs) aims to set behavioural standards for CRAs, such as increasing transparency and improving their standards of corporate governance. The Regulation also puts in place a regime for registering and regulating CRAs and subjecting them to supervision. The aim is that ratings will be qualitatively better than under current standards – 'independent, objective and of adequate quality'.¹⁰
- 3.25 Second, the EU has agreed amendments to the CRD which seek better to align the incentives of lenders with those of investors. These changes prohibit EU-regulated banks from investing in securitisation positions where the originator or distributor does not itself retain a net economic interest of at least 5%.
- 3.26 Third, the European Commission has also proposed new requirements on investor due diligence and originator transparency. From 2011, investor credit institutions will be required to be able to demonstrate that they have a comprehensive and thorough understanding of – and have implemented formal policies and procedures for analysing and recording – the risk characteristics of the securitisation position, underlying exposures and all the structural features of the securitisation that can materially impact the performance of the credit institution's securitisation position. Investors will also be required to establish formal policies and procedures to monitor information on the performance of underlying exposures on an ongoing basis.
- 3.27 We will be monitoring the detailed implementation of these measures to assess their likely impact on mortgage lending. At present, however, we expect these changes to address some of the problems that emerged in the securitised credit model. As a result, they are likely to help constrain poor quality lending and excessively rapid growth of lending into new market segments.
- 3.28 The range of policy changes on liquidity, capital, leverage and securitised credit described above will have a major impact on banks and building societies, including in respect of their mortgage lending. The nature of the effects is two-fold: (1) they increase minimum liquidity and capital requirements and (2) they reduce pro-cyclicality in prudential standards. We can expect these policy changes to increase the amount and especially the quality of capital that banks maintain for their mortgage lending. There are also likely to be wider effects on banks assessment of risk through the economic cycle and the ability and willingness to expand lending rapidly during a boom phase.

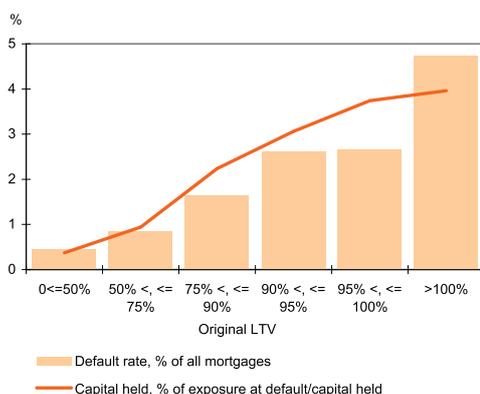
10 European Commission (2008), *Proposal for a Regulation of Credit Rating Agencies*, 2008/0217 (COD)

Differentiation of risk in the current capital regime

- 3.29 Alongside the overall rules on capital and liquidity, the dynamics of the mortgage market are affected by whether our capital regime adequately differentiates between the riskiness of different categories of loan. At present, the capital requirements on deposit-taking lenders for their mortgage loans are defined through one of two approaches, each of which is to some degree sensitive to the risk of the product.
- 3.30 For firms using the **standardised approach**, a fixed percentage of the loan amount is defined that does not vary across product types or through the economic cycle. The requirement does vary by LTV ratio, however, in that the capital requirements increase for mortgages at an LTV of 80% or higher.
- 3.31 The **Internal Ratings Based (IRB)** approach allows firms to use their own models of key risk parameters, subject to certain regulatory constraints, so as to generate capital requirements that may vary by product type, LTV ratio, and other factors. The majority of mortgage lending in the UK is undertaken by major lenders using the IRB approach. And as we shall see in Chapter 4, our preliminary assessment of ten of the largest IRB lenders (comprising 68% of the total UK mortgage market) indicates that the capital they held at the beginning of 2008 was more than sufficient to absorb the losses they suffered on mortgage defaults throughout the remainder of that year.¹¹
- 3.32 Our assessment of the same group of IRB lenders shows that higher-risk products (as measured by LTV ratio) produce higher default rates, lead to higher expected loss calculations, and result in higher capital resources held by lenders. (exhibit 3.1).

Exhibit 3.1:

Risk sensitivity of capital in 2008, by LTV band



Source: FSA

11 A few notable casualties of the crisis, such as Northern Rock and Alliance & Leicester, were using IRB models to assess their credit risk and therefore would have been expected to differentiate the risks in different mortgage products. Our analysis of lenders using IRB models during 2008 indicates that in general such firms were indeed differentiating between different mortgage products in a broadly appropriate fashion. In practice, the failure of these banks was precipitated by their over-reliance on short-term wholesale funding, which made them highly vulnerable to the risk aversion which gripped funding markets from late summer 2007. As discussed in this chapter the FSA's new quantitative liquidity standards will in future significantly reduce the risk of firms' becoming overly reliant on short-term funding. At the same time higher standards of minimum capital will reduce the risk that firms hold capital which is insufficient in quantity and/or quality.

- 3.33 The overall reforms to our prudential capital and liquidity regimes, together with the degree of differentiation in the capital regime by assessed risk of different loans will, we believe, largely address the first problem identified in 3.28: the across-the-board problem of insufficient capital and liquidity standards enabling over rapid credit expansion in a boom period and then withdrawal as an economic downturn takes hold. As long as firms' models provide appropriate differentiation of credit risk the generalised increase in the quantity and quality of minimum capital should impact the capital required for mortgage products in proportion to the riskiness of those products.
- 3.34 They will not, however, necessarily address the second problem identified in that paragraph: the existence of a significant tail of extremely poor borrowing/lending decisions, which raise issues of consumer protection and conduct of business, as much as prudential issues. The issue therefore arises whether it would be possible and desirable to use further prudential policy changes to achieve conduct of business objectives.

Prudential vs. conduct of business levers

- 3.35 To employ prudential policy tools to achieve objectives related to consumer protection would fundamentally change the objectives of prudential policy, as its existing purposes relate to limiting the negative externalities inherent in bank failure, depositor protection (and ultimately protecting the taxpayer) and to maintaining market confidence: not to protecting consumers as borrowers.
- 3.36 Nevertheless, we have considered whether it would be possible to change prudential policy requirements in order to reduce the risk that borrowers will experience detriment, for example through going into arrears and being repossessed. In particular we have examined whether there is a case for increasing capital requirements over and above the amount required to meet prudential standards.

The case for increased capital requirements to disincentivise high-risk lending

- 3.37 On the face of it, we would expect that by forcing banks to hold more capital against high-risk mortgage loans (however defined) we could create disincentives for firms to provide such loans. If effectively implemented, the higher capital requirements would increase the cost of providing such loans and this could induce lenders to reduce their supply of high-risk mortgage lending.
- 3.38 There are, however, four reasons for believing that using prudential levers in this way is unlikely to be fully effective or appropriately targeted:
- First, the extent to which higher requirements feed through to higher product prices and, in turn, to lower volumes of higher risk lending will depend on the price elasticity of consumer demand. In periods of rising house prices, the desirability of getting on – and moving up – the property ladder may result in consumers being willing to take on higher risk and loans even at significantly higher costs.

- Second, borrowers who still take out high-risk mortgages are likely to be paying at least some of the additional capital costs in the form of higher interest rates. Those higher costs make it more likely that any adverse income shock will push the borrower into arrears.
- Third, the extent to which higher costs will be passed through from lender to borrower is uncertain. Typically for the major lenders, high-risk loans (however defined) are a relatively small share of their overall mortgage lending and therefore also of overall capital requirements (even though the risk weights are often much higher relative to standard mortgages). In themselves prudential requirements cannot guarantee that firms pass on the full costs of capital requirements for high-risk loans to the borrowers who take them out.¹²
- Fourth, the impact of higher capital requirements is affected by the level of excess capital lenders hold above the regulatory minimum. If capital requirements were set with the intention of reducing the volume of high-risk lending, and not solely for prudential purposes, lenders may adjust their behaviour. If lenders believe that the minimum capital requirement for high-risk lending was already ‘too high’ compared with any plausible losses, they may choose to reduce the amount of excess capital retained over the regulatory minimum.

3.39 Therefore the impact of higher capital requirements charged on high-risk loans is uncertain. For any given increase in capital requirements which is intended to protect borrowers, the actual degree of pass through and hence impact on the market will be very difficult to estimate.

Conclusion

3.40 Capital requirements and liquidity requirements are already substantially higher for banks and building societies than has been the case in recent years. They will be further strengthened as *The Turner Review* proposals are implemented. Capital requirements in particular will also be re-structured to be counter-cyclical. This should generate more stable and sustainable mortgage lending.

3.41 Increasing capital requirements to achieve objectives relating to consumer detriment is subject to significant uncertainty and it is not clear that the benefits are enough to outweigh the costs and risks of such a fundamental change in approach. It is likely that increased capital requirements will lead to some costs being passed through directly to borrowers taking on high-risk mortgages. Some consumers would be priced out of high-risk mortgages and may be better off as a result, for example, where in fact taking on the mortgage would not have been in the consumer’s best interest. However, borrowers who take on high-risk mortgages despite the increased costs are made worse off and are more susceptible to income shocks pushing them into arrears.

12 To *oblige* lenders to pass on these costs directly in full would require (i) price regulation of at least some mortgage products and (ii) the information and supervisory resources to make the regulation effective.

Q2: Do you agree with our analysis of the implications of applying higher capital requirements to high-risk loans (on top of the prudential reforms) and that to do so would not be likely to protect borrowers from the risks of taking on such loans?

High-risk lenders

- 3.42 There is one area, however, where we think there may be a case for using prudential levers for reasons other than those of financial stability and depositor protection.
- 3.43 As we have already seen (exhibit 2.9), a main driver of the increase in mortgage lending was the expansion of non-deposit taking lenders. Those not consolidated as part of a financial services group, but operating on a standalone basis, are subject to less onerous capital resources requirements compared to deposit-taking banks and building societies. The capital resources requirements for these ‘non-banks’ are set out in our Prudential sourcebook for Mortgage and Home Finance Firms and Insurance Intermediaries (MIPRU).¹³ They amount to 1% of balance sheet assets plus total undrawn commitments or £100k, whichever is higher.¹⁴ Unlike the BIPRU requirements, which are applicable to banks, building societies, and non-banks that are part of a financial services group, the MIPRU requirements do not vary depending on the degree of risk attached to the assets.¹⁵ They also do not restrict the proportion of lower quality capital resources, such as subordinated loans, that can be held to satisfy the obligations.
- 3.44 These firms also used wholesale funding and the existing well-developed intermediary distribution channel in the UK to aggressively grow market share. By 2007, non-banks accounted for approximately 15% of all outstanding mortgage balances.
- 3.45 In order to understand the lending patterns of the lenders operating in the market (including non-banks), we analysed our product sales data (PSD) for a one-year period at the height of the mortgage market (from Q3 2006 to Q2 2007). We looked at PSD data for the top 70 (out of a total of 180) residential mortgage lenders that were operating in the market in 2006/07. They accounted for 98% of the £301bn of total mortgage loans advanced in that period.
- 3.46 For the purpose of this analysis, we defined ‘high-risk’ lending as combining up to four high-risk borrower or product characteristics available on PSD: a high loan-to-value ratio; no income verification; lending to credit-impaired borrowers; and lending for the purpose of debt consolidation. We then calculated for each lender the percentage share of total sales that were undertaken in these four categories; defined percentage thresholds beyond which we considered the lending pattern to be high risk, and converted the results into an ordinal scale between 0 and 4.

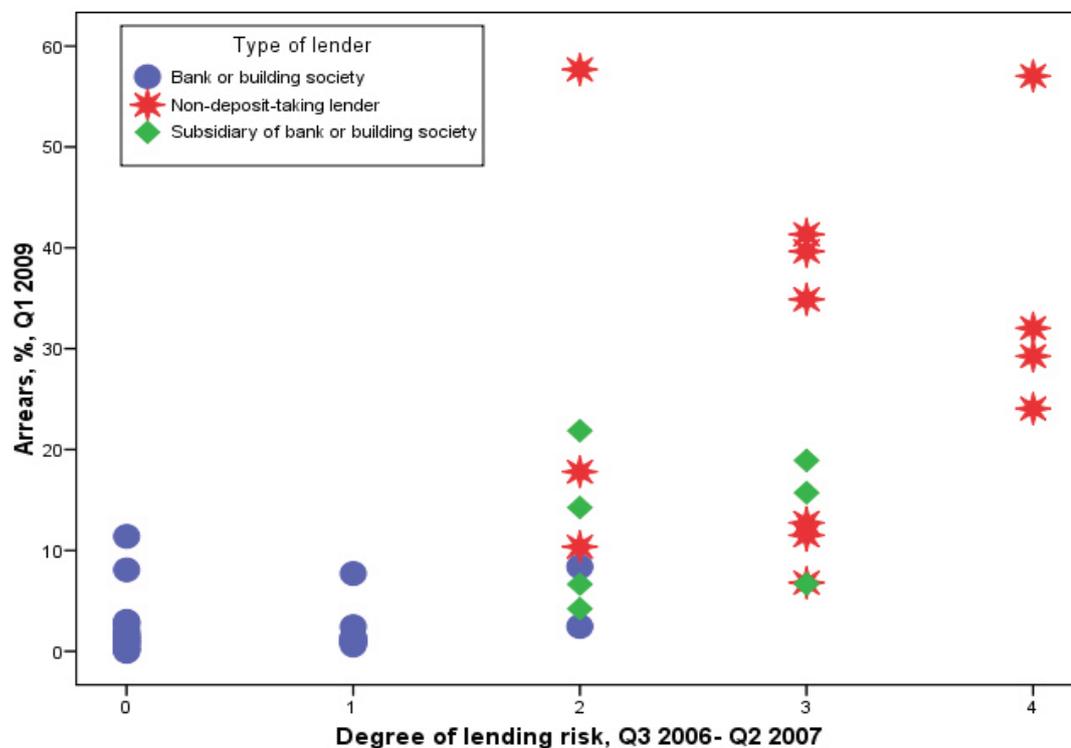
13 CP 98 is the draft mortgage sourcebook, including Policy Statement on CP 70, which was issued in June 2001. This built on proposals originally set out in CP 70: *Mortgage Regulation: The FSA's high level approach*, which was issued in November 2000. We included the final proposals for non-banks in CP 174: *Prudential and other requirements for mortgage firms and insurance intermediaries*, which were issued in March 2003.

14 FSA, *Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU)*, chapters 3 and 4

15 FSA, *Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)*.

Exhibit 3.2:

Arrears rates and degree of lending risk in the UK residential mortgage market, by type of lender



Source: FSA PSD and MLAR

- 3.47 This gave us a simplified and indicative but useful overview of the lending patterns for residential mortgages by different types of lenders (exhibit 3.2) which plots the lending risk of lenders' mortgage portfolios along those four risk categories against their arrears rates in Q1 2009.¹⁶ As can be seen, most (but not all) banks and building societies have low-risk lending patterns and low arrears rates. However, there are approximately 20 lenders that surpassed two or more of our 'high-risk' lending thresholds and had also arrears rates in excess of 5%.¹⁷ They are comprised of one bank/building society; seven subsidiaries of banks or building societies; and 13 non banks.¹⁸
- 3.48 The non-banks are of particular concern. Between 30% and 60% of borrowers on their mortgage books are in arrears. Their expansion was pursued primarily into new, higher-risk consumer segments that had previously enjoyed only limited access to mortgages. High-risk loans were being given to borrowers with very limited and vulnerable means.

16 The arrears rates for 2009Q1 are derived from the FSA's MLAR database and contain mortgages that are held on both the lender's balance sheet and in SPVs. The rates may therefore include mortgage portfolios that were bought and/or sold.

17 Several lenders do not report arrears rates for their subsidiaries separately but report them on a consolidated group level.

18 A further nine Top 70 lenders operated in the market in 2006/07 (all of which were non-deposit taking lenders). As they no longer operated as separate entities in 2009, no arrears data was available for them, which is why they are not shown in the scatter plot.

- 3.49 The arrears rates for non-banks are a strong indication of lending to individuals whose inability to repay was foreseeable and (as discussed in Chapter 2) of a business model based on 'equity lending', that is one built specifically around consumers with impaired credit histories, who are unlikely to be able to repay the mortgage but have equity in their properties on which the lender could ultimately rely.
- 3.50 Another concern is that by 2009, the vast majority of these non-banks had pulled out of the market and are no longer lending. Increased competition in the market is generally a good thing and wholesale funding can help facilitate it. But the quick entry and exit of such a significant supply share has had a particularly damaging impact in the UK where borrowers are currently remortgaging on average every four to five years (and much sooner in the credit-impaired sector) and depend on the continued availability of mortgage deals. In many other countries, borrowers commit to long-term contracts and, once the mortgage has been advanced, are unaffected by subsequent supply withdrawals. The pro-cyclical entry and exit of non-banks in the UK market produces market sustainability issues and reinforces our emerging view that collectively these institutions can bring instability to the market.
- 3.51 We believe that the prudential reform already underway will go some way to addressing the issues around non-banks. Although these reforms will impact more on deposit-taking lenders, there will be an indirect effect on non-banks. The quantitative liquidity standards set out in CP08/22,¹⁹ for example, will apply to deposit takers, in particular large financial groups who in the past provided funding to non-bank lenders. These standards are likely to put upward pressure on the price of providing credit to non-bank lenders: deposit-takers will be required to hold large buffers of highly liquid assets and/or reduce their reliance on short-term funding. As a result, there is likely to be a reduction in available funding and an increase in the cost of funding for non-bank lenders. Overall this is likely to constrain the amount of mortgage lending these types of firms can originate through these means.
- 3.52 A comparative look at the regulation of non-banks in countries with much more stable mortgage markets is instructive: many countries require all lenders (irrespective of whether or not they take deposits) to be authorised as deposit-taking institutions. All lenders are therefore subject to the same prudential requirements. A distinction like that between MIPRU and BIPRU requirements in the UK does not exist. Some other countries do, however, allow non-bank lenders to operate under less onerous prudential requirements but limit the funding means available to them (for example, allowing covered bonds and inter-bank loans, but not mortgage-backed securities).²⁰ We will be considering the lessons of these different approaches further in the context of our overall review of the capital requirements of financial institutions generally.
- 3.53 Changes to our capital and funding requirements are not the only measures we could consider. A number of additional options are open to us to address the risks posed by non-banks. First, our new intensive and intrusive integrated supervisory approach means that we will be intervening at an individual firm level and, where necessary, will act to

19 FSA (2008), Strengthening liquidity standards: www.fsa.gov.uk/pubs/cp/cp08_22.pdf

20 London Economics (2008), Study on the role and regulation of non-credit institutions in EU mortgage markets, Final report commissioned by the European Commission

stop unduly risky business models and strategies. This could include making our continued authorisation of a lender dependent on our being satisfied about the lender's business model.

- 3.54 Another option would be to impose asset limits for specific lenders or types of lenders. This would be akin to the proposed building society guidelines published in June 2009 in our Consultation Paper CP09/17.²¹ This proposed that societies should self-assess their risk management capabilities against defined criteria, and adopt lending policies commensurate with their own level of management skills, systems and controls. It proposed that those lending policies should include board approved 'asset limits' on higher risk lending, indicative levels of which are set out in the CP for each of three broad lending 'approaches'. The proposals in CP09/17 have been calibrated specifically for building societies with the aim of avoiding future financial difficulties, such as those that have emerged in a few societies over the past couple of years as a result of a failure to identify and control the risks arising from diversification away from prime residential lending. Asset limits are one means by which societies can reduce their future vulnerability to difficult market conditions.
- 3.55 Applying such limits for firms engaging in particularly high-risk lending may be an appropriate approach. The Council of Mortgage Lenders (CML) has provided us with transactional data to determine the precise product characteristics of cases in arrears. Analysis of that data has not yet begun but it may help in determining the exact nature of the asset limits that would need to be put in place.

Conclusion

- 3.56 We believe that the prudential policy changes already underway or proposed, combined with our proposed conduct of business reforms will help constrain the level and growth of risky mortgage lending in the future. However, it is uncertain whether that will be enough to address the significant issues seen in relation to non-banks. In addition to paying closer attention to high-risk lending strategies through our business model analysis generally, we will also consider whether it would be appropriate to apply particular asset limits to firms engaging in high-risk lending, and whether the current distinction between prudential requirements for deposit-taking lenders and those for non-banks is fit for purpose.

Q3: Do you agree that more direct intervention through business model analysis; applying asset limits; or increased prudential requirements is required to deal with the consumer and systemic risks posed by non-deposit taking lenders?

Q4: Are there any other considerations that are relevant to the issue of how prudential requirements influence mortgage market outcomes?

21 FSA (2009), *A Specialist Sourcebook for Building Societies: Enhanced supervisory guidance on financial and credit risk management*, FSA CP09/17

4 Conduct of Business reform

- 4.1 For the majority of consumers, the mortgage market has worked well: most will come through this recession meeting their mortgage payments and keeping their homes and are likely to feel fairly happy with the borrowing decisions they made. But some consumers are facing severe hardship and, as we noted earlier, our existing regulatory framework has been shown to be ineffective in constraining particularly high-risk lending and borrowing. We also noted that, although the current downturn in the market and pressure on firms to reduce overall levels of debt has led to a sharp reversal in firms' attitude to risk management, nonetheless, there is still a risk that, as the economic cycle turns, some of the practices and growth experienced before 2007 will re-emerge, if not controlled. We have discussed the fundamental prudential reform already underway and the effect we believe this will have on the mortgage market. This chapter discusses the conduct of business reforms we believe to be necessary to constrain irresponsible behaviour in the next upswing.

Product regulation

- 4.2 The FSA has in the past been reluctant to embrace the idea that it should ban products on the grounds of inhibiting innovation. As explained in *The Turner Review*, our regulatory philosophy has been based on the assumption that (1) firms must be subject to prudential regulation to ensure financial soundness; (2) they must be subject to conduct of business regulation to ensure that consumers are treated fairly and are well-informed; and (3) that product regulation is not required because well managed firms will not develop products which are excessively risky and because well informed consumers will only choose products which serve their needs. The historical approach was therefore based on ensuring full risk disclosure and a reliance on firms' and consumers' judgements.
- 4.3 However, as we have seen (exhibit 2.7), there has been a proliferation of high-risk products in the market and, as we discuss in Chapter 6, consumers either do not or are unable to, use the information available to them to make good borrowing decisions. So we believe a targeted degree of product regulation may be required to help make the market work better for consumers.

Loan-to-value (LTV), loan-to-income (LTI) or debt-to-income (DTI) ratios

- 4.4 One of the open questions posed by *The Turner Review* was whether we should prohibit the sale of loans above certain loan-to-value (LTV) or loan-to-income (LTI) ratios. *The Review* noted that high initial LTV and LTI ratios had played an important part in the rapid expansion of mortgage credit and that, as part of our review of the mortgage market, we would be assessing the strength of the arguments for and against imposing maximum LTV ratios or LTI ratios; analysing the extent to which consumer defaults and bank losses are correlated to either high initial LTV or LTI; and drawing on the lessons from international experience. As part of our analysis into the case for banning the sale of high LTV and LTI loans we have taken into consideration the feedback received to *The Turner Review*.
- 4.5 Some countries already ban high LTV mortgages, including Austria, Poland, China and Hong Kong. The rationale in these countries for prohibiting high LTV mortgages generally relates to limiting credit growth, stabilising volatile property markets and enhancing financial stability.
- 4.6 Other countries have in place an income affordability threshold, including Hong Kong, the Netherlands and China. The nature of these thresholds varies but can include a maximum loan-to-income multiple or a maximum debt-servicing ratio above which a loan must not or should not be provided to a prospective borrower. So we have included debt-servicing ratios in our analysis (see 4.30). The nature of such thresholds is more typically a guideline, as is the case in the Netherlands and Hong Kong. However, some countries take a stricter approach and ban the provision of loans above the stipulated threshold, such as China.
- 4.7 So far, the evidence in support of implementing LTV or LTI limits in the UK is not overwhelming, though we need further analysis before we finalise our views. It is not clear that the potential benefits would justify us banning the sale of loans above certain LTV or LTI ratios. This does not, however, rule out the application of such ratios in future in the light of further analysis of the pattern of arrears and repossessions as the current downturn continues, or as tools that could be employed as part of a wider counter-cyclical macro-prudential framework (which is out of the scope of this review).

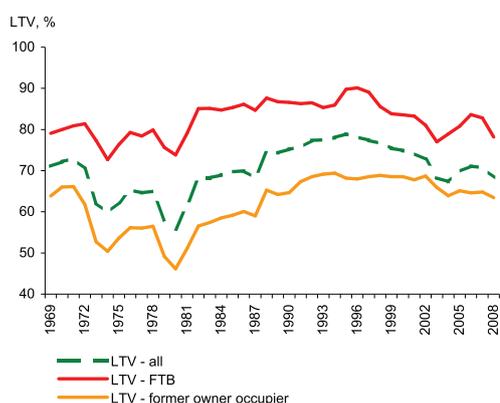
LTV ratios

- 4.8 The UK, like the US, saw very rapid growth of household debt as a percentage of GDP, with that growth dominated by mortgage credit. Some commentators have suggested that this growth in mortgage credit was underpinned by lenders expanding far too rapidly by offering very generous LTV ratios. Therefore, for some people, it seems obvious that we should look to constrain lending and over-rapid credit growth by banning high LTV loans.

- 4.9 But these conclusions are not obvious. A closer look at the data suggests a more complex reality which we need to take into account in designing appropriate long-term regulatory policy. Our evidence suggests that an expansion in high LTV lending was not a key trend underlying the expansion of mortgage credit in the UK, and that there was a major divergence between what has been happening to initial LTVs and initial LTIs.
- 4.10 In February 2007, mortgage loans with a 90% or higher LTV comprised 70% of the products available in the market. Given these trends in the availability of high LTV products, it would be easy to assume that an increasing proportion of loans were being taken out at high LTVs.
- 4.11 However, average LTV ratios for house purchase have generally been falling since around 1997 (exhibit 4.1). Furthermore, the proportion of mortgages advanced for house purchase issued at high LTV ratios (90% or higher) during the recent credit boom was lower than in the 1980's and 1990's (exhibit 4.2).

Exhibit 4.1:

Average Loan-to-Value, by type of borrower



Source: DCLG, SBS/SML/RMS

Exhibit 4.2:

Proportion of borrowers taking higher LTV loans (90%+)



*Note: data excludes properties sold at discounted prices in 1983 - 2001

Source: SBS/SML, FSA PSD, FSA calculation

- 4.12 There are some gaps in historical data coverage that we are not able to resolve. Our analysis of LTV trends is based on loans for house purchase so it excludes some loan transactions, such as re-mortgaging. Loans for re-mortgaging have made up a significant share of the market.²² However, the average LTV ratio for re-mortgagors is typically lower than the average LTV for house purchase.²³ So including remortgaging data is unlikely to change the historical trends we have observed.
- 4.13 Regardless of data coverage issues, there is a valid explanation for the trends we have observed in high LTV lending and it lies with rising house prices. Average LTI ratios did not increase as fast as house prices increased relative to incomes (the latter being measured by the price to income ratio, see exhibit 4.3).

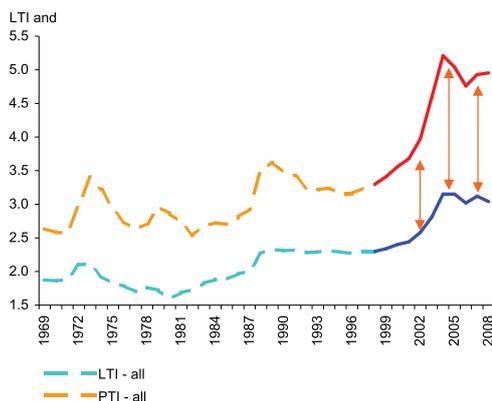
22 In 2007, re-mortgaging comprised approximately 50% of new sales of FSA regulated mortgages (FSA PSD).

23 In 2007, the average LTV for house purchase sales (including FTB, home-movers and Right to Buy) was 68% and the average LTV for remortgaging sales was 52% (FSA PSD).

4.14 As a result, the gap between the value of a house and the amount which people could borrow widened. Would-be-borrowers had to delay their purchase to save more. First-time buyers, who did not benefit from previous price rises, were affected the most. As a result, deposits increased (exhibit 4.4) and the share of high LTV lending (90% or higher) for house purchases fell. First-time buyers met their higher deposit requirements either by delaying buying their home for longer or, where possible, by drawing to a greater extent than before on family support or loans.

Exhibit 4.3:

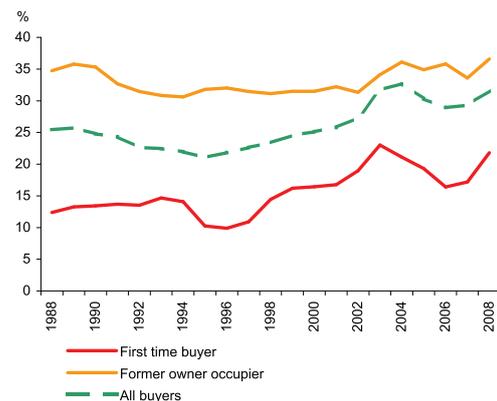
Average Loan-to-Income compared to Average Price-to-Income



Source: DCLG, SBS/SML/RMS

Exhibit 4.4:

Deposit as a percent of price, by type of borrower



Source: DCLG, SBS/SML/RMS

- 4.15 So high LTV lending does not appear to have played such a critical role in falling credit standards and over-rapid credit growth as first supposed. However, this does not rule out the application of an LTV threshold as part of a wider counter-cyclical macro-prudential framework (which is out of the scope of this review).
- 4.16 The role of high LTV lending in over-rapid credit growth is not, however, the only criterion against which we might assess the case for and against banning high LTV loans. A second argument often made in favour of banning high LTV loans is that it would protect individual consumers against the consequences of over-risky borrowing, namely unaffordable loans and repossessions.
- 4.17 The correlation between LTV and defaults is not automatic given that LTV is not a direct measure of income or whether a consumer can afford to pay each month. But there are some arguments why a correlation may exist: a lower LTV ratio means that a borrower has greater equity in the property which could increase their willingness and incentive to repay; and borrowers without equity can be less able to borrow to survive income shocks.
- 4.18 To help assess the consumer protection arguments for banning high LTV loans, we have looked at the extent to which defaults are correlated with high initial LTVs. Again, the evidence does not suggest straight-forward conclusions and we need further careful analysis before finalising our views.

- 4.19 In the UK, there is evidence of a correlation between LTVs and defaults. We are yet to see the peak of defaults in this recession. Nevertheless, our analysis found that default rates for ten of the largest UK mortgage lenders²⁴ have generally been higher at higher LTVs during 2008 (exhibit 4.5).

Exhibit 4.5:

Default rate of 10 of the largest lenders by mortgage type and LTV at origination during 2008

Loan-to-Value ratio	Buy-to-let	Credit-impaired	Other	Self-cert	Standard	All types
0<=50%	0.51	3.97	0.40	1.02	0.40	0.46
50% <, <= 75%	0.74	5.93	0.65	1.76	0.75	0.86
75% <, <= 90%	2.08	7.57	1.30	3.42	1.24	1.65
90% <, <= 95%	8.13	8.56	1.98	5.26	2.56	2.62
95% <, <= 100%	6.33	8.97	2.38	9.24	2.50	2.66
>100%	3.40	16.52	1.70	6.44	5.83	4.74
ALL LTV BANDS	1.58	6.44	0.88	2.97	1.08	1.21

Note: the default rates shown in each cell are weighted by the number of accounts in each firm, of each type or in each LTV band, as appropriate.

Source: FSA

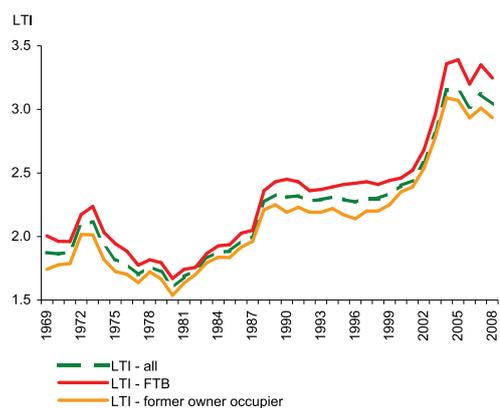
- 4.20 But although there is a correlation, LTV appears much less important than other factors. For example, standard mortgages of 95-100% appear less likely to default than self-certified mortgages of 75-90%. It is the differences in the category of mortgage (i.e. whether it is a self-certified or credit impaired product) which are a much more powerful predictor of default.

LTI ratios

- 4.21 Unlike high LTV lending, the evidence suggests that a growing share of high LTI lending was a significant factor in the rapid growth of mortgage credit prior to 2007.
- 4.22 In the UK, mortgages with an LTI of 3.5 or higher comprised 28% of mortgages advanced in 2007. Average loan-to-income ratios for house purchases rose from less than twice the average income in the 1970's and 1980's to more than three times the average income at the market peak (exhibit 4.6). An LTI in excess of 3.5 times

24 The 10 lenders comprised about 68% of the total UK mortgage market at March 2009 (sourced from FSA data on the amount of debt outstanding for these 10 lenders and Bank of England data on the size of the total UK mortgage market at this date).

Exhibit 4.6:
Average Loan-to-Income, by type of borrower



Source: DCLG, SBS/SML/RMS

income that was mostly unheard of in the 1970's and 1980's became common practice in the run up to the crisis.

- 4.23 Again, it may seem obvious to some that we should prohibit such high LTI multiples from becoming common practice in future. In fact, if we had no evidence available, we might intuitively conclude that high LTI ratios should be a good predictor of defaults given that LTI ratios directly relate to income. However, a closer look at the data suggests somewhat counter-intuitively that LTI is a worse predictor of defaults than LTV.
- 4.24 Our evidence to date suggests that LTI is not a strong or consistent predictor of arrears. We found that default rates for ten of the largest lenders²⁵ were not strongly related to LTI in 2008 (exhibit 4.7). As with LTVs, differences in the category of mortgage are much more powerful predictors of default.

Exhibit 4.7:
Default rate (%) of 10 of the largest lenders by mortgage type and LTI at origination during 2008

	Buy-to-let	Credit-impaired	Other	Self-cert	Standard	All types
Loan-to-Income ratio						
<=2.5	1.54	5.44	0.50	3.06	0.68	1.56
2.5<, <=3.5	1.53	7.25	0.97	3.24	1.36	1.35
3.5<, <=4	1.59	6.07	1.35	2.59	1.19	1.18
4<, <=4.5	1.72	5.92	1.46	2.16	1.04	1.22
4.5<, <=5	1.99	5.14	1.65	1.42	0.98	0.88
>5	2.02	5.18	1.75	1.95	1.07	1.43
All LTI values	1.58	6.44	0.88	2.97	1.08	1.21

Note: the default rates shown in each cell are weighted by the number of accounts in each firm, of each type or in each LTI band, as appropriate.

Source: FSA

25 See footnote 24.

- 4.25 While an LTI ratio can provide a measure of income leverage, it does not accurately reflect a consumer's financial position and ability to repay a loan. So the evidence we have so far suggests that a ban on high LTI loans would be unlikely to protect consumers from arrears and repossessions in future.
- 4.26 In summary, we have found some evidence that high LTV and LTI lending has contributed to mortgage market problems, but not that they are the most crucial drivers. Increased high LTI lending has contributed to very rapid credit growth, but LTI levels appear to be surprisingly poor predictors of risk for standard mortgages. There is a correlation between high LTVs and default probability, but LTVs did not increase in the pre-crisis period. And there are other factors (for example whether the mortgage is self-certified or not) which are stronger predictors of credit problems.
- 4.27 Given this nuanced picture, the potential disadvantages of across-the-board LTV and LTI caps combined with the availability of other potential levers, means that we are not yet convinced that the case has been made for an outright ban of loans above some defined LTV or LTI levels.
- 4.28 But these conclusions are tentative and could be reviewed in the light of arguments presented in response to this DP, or in the light of either (1) more detailed analysis of the arrears and repossessions experience which will become increasingly available over the coming months or (2) consideration of the macro-prudential levers which the Bank of England and the FSA may need to use to achieve wider macro-prudential objectives.
- 4.29 Our current view is that more targeted policies may be a more appropriate response. These could include banning potential high risk categories of mortgage, such as Non-Income Verified (NIV) and/or banning specific combinations of high-risk indicators, such as high LTV and/or LTI and/or credit impaired. We consider these options further below.

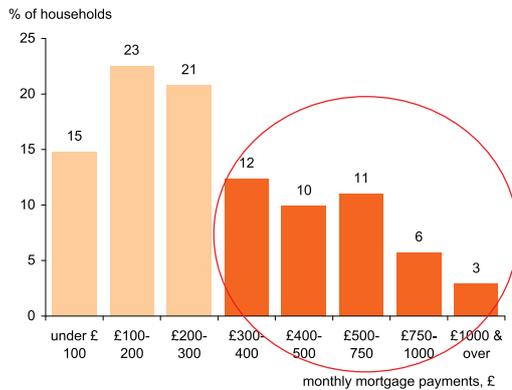
Debt to income (DTI) ratios

- 4.30 In addition to considering LTV and LTI caps, we also considered the possibility of imposing a total debt-to-income cap in order to protect consumers with existing financial commitments from taking unaffordable mortgages.
- 4.31 In 2006-2007, there were more than 8 million owner-occupied households with a mortgage secured against the property. More than a third of these households (nearly 3 million families) had annual income below the national average of £30,700.²⁶
- 4.32 Evidence from the Department of Work and Pensions (DWP) suggests that in 2006/2007 around 40% of the lower income households, those with under £1,000 disposable income per month, were using more than half of their disposable income to pay for their mortgage, leaving very little for other expenses such as bills, food and other consumption (exhibit 4.8). Worryingly, in 2006/07 around 3% of households with £1,000 of disposable income were using all of their income to cover their mortgage repayments of £1,000 plus, which means that they were left with no form of income to cover other expenses such as food and bills.

26 DWP Family Resources Survey, DCLG

Exhibit 4.8:

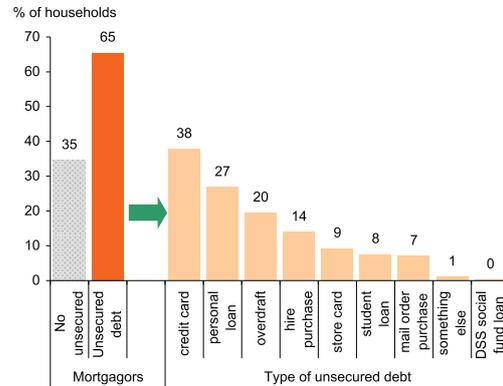
Mortgage payments by households with disposable incomes of less than £1,000 a month, 2006/2007



Source: DWP Family Resources Survey

Exhibit 4.9:

Unsecured debt holdings by mortgagors



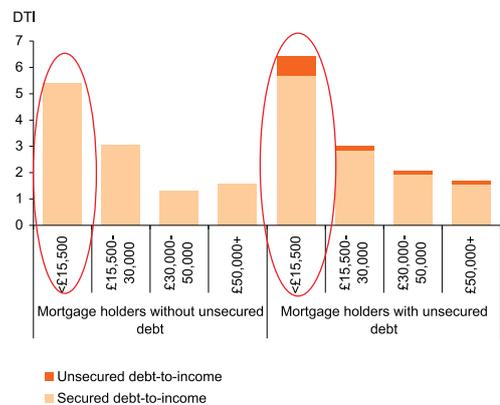
Source: 2008 NMG Research Survey "The financial position of British households", FSA calculation

4.33 Households facing mortgage repayments and other debt repayments that covered a large proportion of their income may have been forced to use other forms of debt to maintain repayments on their mortgage. Over the longer term, reliance on such borrowing is likely to be the factor which contributed to the deteriorating cycle where a consumer borrows more in order to be able to make repayments, which get increasingly expensive as the overall debt becomes larger and more unmanageable. In 2008, two-thirds of mortgage holders had some form of unsecured debt (exhibit 4.9).

4.34 Contrary to anecdotal evidence, it appears that the overall debt exposure of mortgagors with and without unsecured debt commitments is roughly similar (exhibit 4.10). It is the poorest borrowers who are the most exposed.²⁷

Exhibit 4.10:

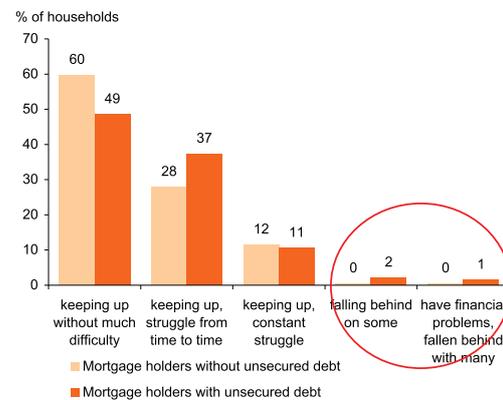
Debt-to-income ratios of mortgage holders, by gross income group, 2008



Source: 2008 NMG Research Survey "The financial position of British households", FSA calculation

Exhibit 4.11:

How well mortgage holders are keeping up with their bills and/or credit commitments, 2008



Source: 2008 NMG Research Survey "The financial position of British households", FSA calculation

27 According to 2007 PSD, 4% of all mortgages were sold to those earning £15,000 or less

- 4.35 Yet, according to these surveys, it is a relatively small proportion of mortgagors who fall behind on their payments (exhibit 4.11). Notably, nearly all have unsecured debts.
- 4.36 According to our internal research, repossessions are concentrated in the low income/‘credit hungry’ borrower groups. Only 12% of the sample of repossessed properties analysed had only the original mortgage secured on them. The remainder of the properties have either been remortgaged (usually to withdraw equity); or had a subsequent charge, a charging order, or both applied to them. It is consumer debt as a whole, not just the mortgage, that is unaffordable.²⁸
- 4.37 The evidence suggests that some form of regulatory intervention could be necessary in order to protect consumers from the consequences of unaffordable borrowing. Prescribing how much debt, in relation to income, a consumer may take on before the burden becomes unaffordable is a seemingly attractive option.
- 4.38 However, while a DTI ratio does provide a measure of income leverage, it does not accurately reflect a consumer’s financial position and ability to repay a loan.
- It is indiscriminate, in that it does not differentiate between consumers of different financial standing, as long as, proportionally, their debt commitments are equal. From a DTI perspective, borrower A earning £10,000 per year with £20,000 debt and borrower B earning £100,000 per year with £200,000 debt have equal levels of indebtedness as both have a DTI of two. However, their ability to service their current debt and/or take on more debt is not equal, with borrower B being in a much better affordability position;
 - As a measure of leverage, DTI also has limitations as the cost of different debt products is dissimilar; so the same aggregate level of debt made up of different debt-types is not directly comparable (for example £20,000 of credit card debt vs. £20,000 of mortgage debt);
 - Being a proportional measure, the ratio does not take into account the absolute level of a consumer’s income, and, therefore, the net disposable income which is left after debt-servicing commitments are met.
- 4.39 As with LTV and LTI caps, our view is that this would be a fairly blunt tool. While DTI does provide a good measure of income leverage, it does not take into account a consumer’s expenditure that is not related to debt servicing and does not accurately reflect a consumer’s financial position and ability to repay a loan. Whatever the level of the cap, there will be ‘conforming’ consumers on lower incomes who could not afford their debt commitments and ‘non-conforming’ consumers on higher incomes who could comfortably repay their loans. We think that what really matters is a proper assessment of affordability at an individual level.

Q5: Do you agree with our analysis that, on the grounds of consumer protection, there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds?

28 This is based on a sample of 600 auction house repossession sales

Prohibiting loans to borrowers exhibiting certain multiple high-risk characteristics

- 4.40 We have suggested that across-the-board caps on any one ratio – whether LTV, LTI or DTI – are unlikely to be adequately targeted on the tail of severe problems in the mortgage market to justify their disadvantages. There may however be a case for prohibiting certain combinations of high LTV, LTI, DTI or other high risk indicators, such as unstable income or impaired credit history. We have not yet completed our analysis of what causes high default rates and our ability to draw robust conclusions will grow as further data on arrears and repossessions in this recession becomes available, but we believe this may be, in principle, an attractive approach.
- 4.41 The Council of Mortgage Lenders (CML) has provided us with transactional arrears data which we propose to match with PSD to enable us to determine the precise product characteristics of cases in arrears.²⁹
- 4.42 Exhibit 4.12 contains a summary of the high-risk mortgage characteristics (in terms of product features or borrower types) used by the market. All of them can potentially result in higher arrears rates. Many of these risks and ways of addressing them are considered in this DP. We are not excluding those risks from our ongoing high-risk combinations analysis, though their impact should be lessened by other policy measures.
- 4.43 To give an example of a possible ‘toxic’ mix, we have used three quantifiable risks (high LTV, credit-impaired and unstable income) shown in the yellow section of exhibit 4.12. Their combinations could potentially substantiate a ban if the analysis shows that the probability of defaults amongst consumers with such mortgages is significantly higher compared to the market average.
- 4.44 Exhibit 4.13, in turn, shows the ‘risk pockets’ of such product combinations and the size of the relevant market segments. At present, we do not have enough evidence to determine which of these combinations (if any) result in higher arrears rates. We should be in a position to make a decision on whether further action is appropriate once the analysis of transactional arrears data is carried out.

²⁹ The data was collected for us by CML, from a sample of banks, building societies and specialist lenders. The dataset contains approximately 249,000 transactions, which are in arrears or repossessed, from 22 firms.

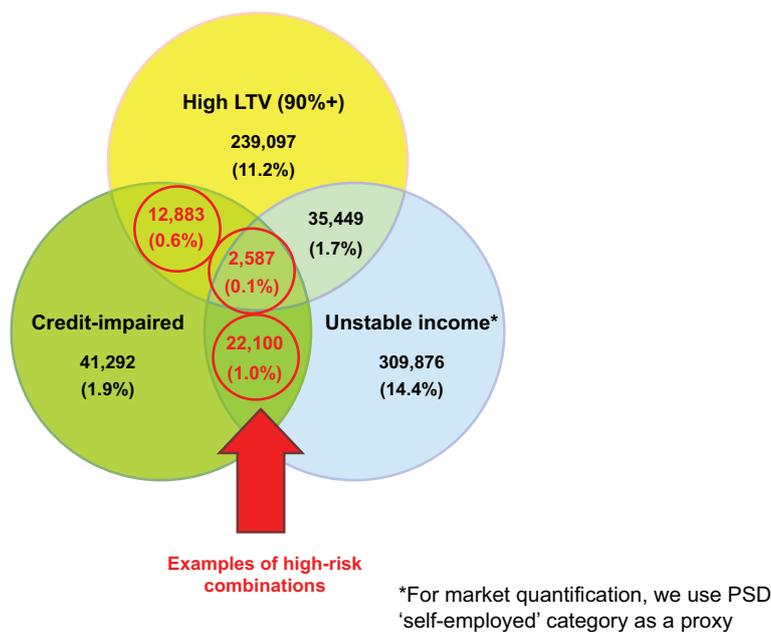
Exhibit 4.12:

High-risk products/borrower types

What are high-risk products/borrower types?	Why are we concerned?
Interest-only mortgage	A consumer may take an interest-only mortgage because s/he cannot afford a repayment mortgage
Offset mortgage	Debt can increase above affordable levels through an overdraft facility
Income non-verified mortgage	Income can be overstated
Low income mortgage	Income may not be enough to service a mortgage, particularly if consumer's circumstances change for worse
High LTI mortgage	Consumers have higher debt in relation to income (note that LTI is not a good measure of general affordability and should be viewed alongside absolute income)
Remortgage with extra money raised	Consumer increases level of debt, potentially because s/he experiences financial problems
Mortgage term post-retirement	Income may not be sufficient for mortgage servicing after consumer retires
Unstable income	Future income can be unstable or uncertain
High LTV mortgage (90%+)	Consumers have small deposit in relation to loan size which may indicate inability or unwillingness to save
Impaired credit history mortgage	Consumers have previously defaulted on their financial commitments

Exhibit 4.13:

Risk combinations illustration: number of mortgages, by type, and their proportion of total lending, 2007



Source: FSA PSD

4.45 Further work will also be needed to assess the implications of this, for example – the practical issues around implementation and transitioning existing borrowers with those multiple high-risk characteristics. But we believe that prohibiting such sales might help to protect consumers from the consequences of imprudent borrowing and might help to protect lenders against the consequences of imprudent lending.

Q6: Do you consider that the FSA should prohibit the sale of mortgages to borrowers with multiple high-risk characteristics? If yes, what particular combinations of risk factors should the FSA consider prohibiting and why?

Non-income verified mortgages

4.46 In our view, a clear and non-controversial case for product regulation is non-income verified (NIV) mortgages. These products were designed initially by the market to meet the needs of self-employed borrowers but grew way beyond the consumer groups for which they were originally intended.

4.47 Whilst, as we have seen, property value increased by almost 200% in the decade before the onset of the financial crisis, the growth in average earnings did not keep up and amounted to only 50% growth in the same period. The purchase of a property, as a result, became increasingly difficult for many people.

4.48 We have already noted that both lenders and borrowers assumed that debt burdens would fall with continuing house price appreciation and so the approach to assessing affordability relaxed. Lenders were increasingly prepared to allow borrowers to self-certify their income and, as house price increases rapidly outpaced income growth, many applicants were tempted and willing to inflate the income they stated on their applications.

4.49 The first decade of this century had seen a rapidly increasing number of NIV mortgages. NIV mortgages are mortgages that are either ‘self-certified’ or what the industry has come to refer to as ‘fast tracked’. Self-certification (‘self-cert’) is a product for which the lender guarantees not to require any proof of income, and usually charges a premium price for the greater risk incurred. Fast tracking refers to the streamlined processing of an application during which the lender, subject to certain risk thresholds being met (such as LTV ratios or credit scorings) refrains from requiring proof of income, but retains the right to ask for this at any time. Unlike self-cert, the price of the mortgage tends to be the same as the equivalent non fast tracked product. And unlike self-cert, which is typically a specific product offered to, or requested by, the consumer, the borrower of a fast tracked mortgage is often not aware of being fast tracked.

- 4.50 Accurate time series data to track the growth of NIV mortgages is difficult to obtain. For the period before the FSA's regulation of mortgages in 2004, third party sources suggest that sales had grown by 29% annually for each of the years 2000 to 2004.³⁰ FSA product sales data for the subsequent, FSA-regulated period confirms this trend. And by the time the mortgage market reached its height in 2006/07, 45% of all mortgages were advanced on a NIV basis.
- 4.51 No other country that we assessed for comparative purposes featured a similarly significant NIV market segment, with the exception of the USA and Ireland, both of which have experienced a boom in mortgage credit and house prices followed by a severe reduction in both.
- 4.52 It is quite clear from the volumes of NIV business transacted that it expanded significantly beyond the consumer segment for which it had originally been designed. Individuals with regular employment were taking out self-cert mortgages and lenders were willing to allow this, whether the stated income and the reason to self-certify their income appeared plausible or not.
- 4.53 Not surprisingly, a large number of the borrowers who took out such mortgages fell into arrears soon after. It is difficult to analyse arrears rates separately for self-cert mortgages, as many statistics capture both self-cert and fast tracked mortgages in the same category. However, arrears rates can be up to three or four times higher than that of an income verified borrower. And the arrears rate is even higher if the transaction features additional risk characteristics, such as a credit-impaired borrower or a high LTV ratio.
- 4.54 Some lenders also started to blur the lines between self-cert and fast tracked products. While the former represented a high-risk product due to the perceived income uncertainty, the latter was the acceleration of an internal process that was said to be reserved for borrowers with a particularly low credit risk (usually measured in terms of LTV ratio, LTI ratio, credit score or similar metrics). Yet the distinction became blurred over the years as lending standards and risk thresholds decreased, and fast tracking was being applied, and often sold explicitly, to ever riskier applicants. Some market analysts now suggest that, like self-cert, fast tracking has become an adverse loan characteristic that produces arrears rates that are worse than those of income-verified products.³¹
- 4.55 This market segment has also shown itself to be unsustainable. At the height of the market in August 2007, 44 lenders offered self-cert products, a figure that dropped to 22 in August 2008 and to a mere two lenders by August 2009.³² Self-cert as a product has experienced a much more severe contraction than the overall mortgage market. Fast track has also been impacted by the downturn and although some lenders still employ it, they only do so at much lower risk thresholds (for example, LTVs of 60% or less).

30 Datamonitor (2005), *UK Self Certification Mortgages 2005*; Mortgage Introducer (2007), *Self-cert: the story so far*, 13 January

31 Moody's Investors Service (2009), *What Drives UK mortgage loans to default*.

32 Provider and product statistics provided by Moneyfacts

- 4.56 We have considered a number of options for addressing these concerns. For example, whether we should implement a rule that would allow self-cert products to be sold to the self-employed only, but not to salaried applicants. The problem with this approach is that it is very difficult to define and delineate accurately between the ‘employed’ and ‘self-employed’ – and it could be circumvented by applicants registering a business to gain supplementary self-employed income on the basis of which they could then apply for a self-cert mortgage.
- 4.57 In our view, the best way to deter individuals from applying for, and lenders from accepting, inflated applications is to require income verification in every case. We can think of no reason why the self-employed or contract workers would not be able to verify their income. An income flow that is ‘non-regular’ and fluctuating is not equivalent to, nor does it imply, one that is ‘non-verifiable’. Even income that is received only once or twice a year should be capable of verification.
- 4.58 Many consumers would not have been given unaffordable mortgages if they had been required to prove their income. Moreover, many credit-impaired consumers may never have obtained a mortgage at all if firms had been required to verify their income and assess whether they had sufficient free disposable income to afford the mortgage payments. We believe that requiring income to be verified in every case coupled with a thorough affordability assessment is key in making this market work better for all participants.
- 4.59 How this proposal may be implemented needs further analysis. Given the way that some lenders have blurred the distinction between self-cert and fast track (for example, by marketing fast track mortgages as ‘guaranteed without income verification’) and because some analysts now suggest that fast tracking has become an adverse loan characteristic, our intention is that income will need to be verified for both self-cert and fast tracked mortgages. This does not prevent a mortgage application from being fast tracked where appropriate, for example while awaiting local searches or title deeds, but fast tracking will only be possible once income has been verified.
- 4.60 We expect making income verification a requirement in every case to produce various benefits, including:
- a reduction in the number of unaffordable and unsuitable mortgage transactions in the market;
 - a decrease in arrears and repossession rates;
 - an improved transparency for investors and other interested parties of the creditworthiness of mortgage books;
 - a reduction in mortgage fraud; and
 - an improved confidence in, and therefore sustainability of, the market more generally.

Q7: Do you consider that requiring verification of income by the lender for all mortgage applications is a viable option, and one which is sufficient to ensure responsible and sustainable levels of mortgage lending?

Sales regulation

Affordability assessments

- 4.61 When developing the existing mortgage regime, we assumed that firms would have a prudential self-interest to manage their credit risk responsibly and therefore that prescriptive conduct requirements were not required. The current regulatory requirements are therefore aimed at curtailing predatory lending practices and are pitched at a high-level so as not to unduly restrict the different affordability methodologies that had been developed within the industry.³³
- 4.62 As we saw in Chapter 1, our assumption about firms managing their credit risk responsibly has been shown to be wrong in many cases. In our view, a key problem underlying many of the issues in the mortgage market has been firms' failure to perform proper affordability checks.
- 4.63 We consider that there could be considerable scope to strengthen our requirements and be more explicit about the standards we expect. This applies to the balance of responsibility between lenders and intermediaries; the requirements for the affordability assessment more generally; and the requirements for the assessment of interest-only products.

Lenders bear ultimate responsibility for affordability assessments

- 4.64 The current mortgage rules place regulatory burdens on both lenders and intermediaries to assess an applicant's ability to repay. Given that many consumers rely heavily on advice from intermediaries, the requirements are more onerous on the latter than the former.
- 4.65 However, the FSA's thematic work on debt and affordability in 2007/2008 found that these parallel requirements have failed to produce the desired outcomes.³⁴ An assessment of lenders' and intermediaries' separate case files of intermediated mortgage sales found that the lender often assumed the intermediary had checked the applicant's ability to repay, while the intermediary assumed the lender had done so.
- 4.66 We therefore propose to change our mortgage rules to make it clear that ultimate responsibility for affordability lies with the lender irrespective of the distribution channel chosen, as it is the lender who bears the risk of holding the mortgage on their book. We will hold lenders accountable for the lending decisions they have taken.
- 4.67 This does not imply, however, that we should necessarily reduce our affordability requirements for intermediaries (see chapter 4.1).

33 See, for example, MCOB and MCOB 4.7.7

34 Mortgage Effectiveness Review Stage 2 http://www.fsa.gov.uk/pubs/other/MER2_report.pdf
Mortgage Quality of Advice process <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/001.shtml>

Q8: Do you agree with our proposal to require lenders to take ultimate responsibility for affordability?

Prescribing affordability assessments

- 4.68 Past thematic reviews of responsible lending practices revealed some serious failures with regard to the clarity and transparency with which lenders assess affordability of applicants in the ‘subprime’ segment of the market.³⁵ We have also observed more generally that lenders fail to assess applicants’ expenditures and often rely solely on the value of the underlying collateral.
- 4.69 At present, the FSA does not prescribe any standardised approach to assessing a consumer’s ability to repay a mortgage. As a result, current practices in the marketplace vary. The following approaches to assessing affordability of mortgages are common:
- *income multiples* which are fixed either for all borrowers or for groups of borrowers (for example, different multiples may apply for single-income and joint-income applicants). In most cases, gross income is used as a basis; and
 - *affordability models* which calculate the loan amount that a borrower can afford based on assessment of income and expenditure. The level of collected detail, decision algorithms and passing criteria vary.
- 4.70 Research into mortgage underwriting practices conducted by CML and Oxera in 2006 showed that large lenders were more likely to use affordability models than small lenders, which were more likely to rely on income multiples (exhibit 4.14).³⁶ The use of affordability models is likely to be higher today than this survey evidence suggests, given a rising trend in their use.
- 4.71 We consider the move to affordability assessment models to be a significant improvement as it means lenders can take into account differences in personal circumstances when assessing how much debt a borrower can afford to repay. An advantage of affordability models over income multiples is that they explicitly take into account an applicant’s expenditure, thereby focusing on the consumer’s free disposable income, unlike income multiples where the expenditure data is ignored.
- 4.72 There is clearly a responsibility on all lenders to extend credit only where a consumer can afford it and, in our view, a robust assessment of both income and expenditure is key to ensuring affordable mortgages. As we have already discussed, we are proposing to make income verification a regulatory requirement for all mortgage applications. In addition, we propose to require all lenders to assess the level of a consumer’s expenditure in determining the affordability of a mortgage product, to ensure that lending decisions are based on a consumer’s free disposable income.

35 FSA (2007), “*FSA finds poor practice by intermediaries and lenders within sub-prime market*”; press release <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml>

36 Available at <http://www.cml.org.uk/cml/filegrab/58-uk-mortgage-underwriting.pdf?ref=4767>. The current usage of affordability assessments by all types of lenders is likely to be higher than depicted. The use of affordability models was assessed to be on the rise at the time of the survey, with 40% of respondents without a model considering getting one in future.

4.73 There may be some simple metrics, such as LTV or LTI thresholds, which would mean that full affordability checks would not be necessary. But ensuring that mortgages are affordable is the cornerstone of our review and central to our work to protect consumers and therefore our starting point is that this requirement should apply across the market.

Current affordability assessments

4.74 Amongst lenders who already incorporate expenditure data in their affordability assessment models, the level of detail and the categorisation of expenditure items vary. Expenditure information is often based on a combination of data provided by the mortgage applicant and obtained from other sources, such as ONS.³⁷

Exhibit 4.14:

Methods of affordability assessments used by lenders, %

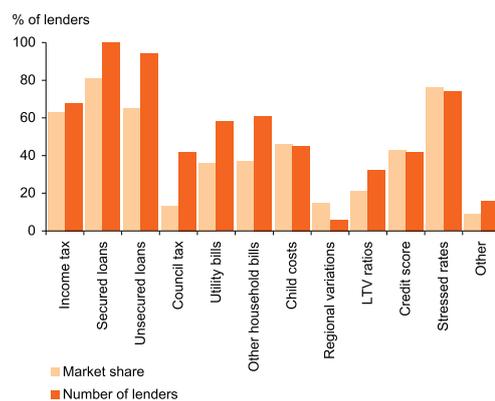
Size of lender	Income multiples only	Affordability model only	Both income multiples and affordability model
Small	62	8	30
Medium	48	5	47
Large	32	32	36

Source: CML

4.75 Exhibit 4.15 illustrates the most common factors used: secured debt servicing; unsecured debt servicing; stress tested interest rates; utility bills and other household bills; and council tax.

Exhibit 4.15:

Factors in affordability assessment models, by frequency of use (2006)



Source: CML

Free disposable income

- 4.76 A mortgage is affordable if its level and terms allow the consumer to meet current and future payment obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of consumption.
- 4.77 We believe therefore that a lending decision should be based on the size of consumers' free disposable income (i.e. income net of all expenditure). An example of current industry best practice in establishing this is depicted in exhibit 4.16. **This is used for illustrative purposes only** and our views on the expected classification and detail of assessed expenditure will be informed by responses to this DP and further discussions with the industry in our working groups.

Exhibit 4.16:

Free disposable income: industry current 'best practice' illustration of calculation

+ Gross income	Gross income (permissible items only)
- Committed expenditure (Layer 1) for applicant(s) and dependents	Income tax and NI Servicing of existing secured and unsecured debt Utility bills and other household bills Council tax Service charges or land rent Shared ownership rent Cost of investment vehicle to repay interest-only loan Insurance premiums Pension contributions Nursery/college/school/university fees Alimony and maintenance payments TV license and communication Regular savings Other existing commitments
- Personal expenditure (Layer 2) for applicant(s) and dependents	Food and drinks Alcohol and tobacco Clothing and footwear Household goods and services Health and personal care Transport Recreation, culture, restaurants and hotels Holidays Other miscellaneous goods and services
- Contingency expenditure (Layer 3)	Prudent allowance for any missed or understated expenses (non-zero level at lenders discretion)
= Free disposable income	Basis to be used by lenders to assess consumers borrowing capacity

- 4.78 **Free disposable income** is the amount of money available for mortgage servicing that is calculated as gross income minus expenditure. This is the amount that a borrower can afford to pay towards the mortgage.
- 4.79 **Consumer's borrowing capacity** should be assessed on the basis of this value using a set of assumptions (that we propose to prescribe), such as:
- capital repayment mortgage;
 - 25-year term or term requested by a consumer, whichever is shortest;
 - stress test for increase in interest rates (for example, current standard variable rate of the lender + 2 percentage points);
 - current and expected value of collateral should **not** be a factor in assessing affordability of a mortgage, nor should any future events that may inflate consumer's borrowing capacity, such as uncertain increases in income or reduction in expenditure.

Individual borrowing capacity

- 4.80 We also see a strong case to prohibit mortgages being sold to consumers who have a negative, zero or low borrowing capacity.³⁸ Borrowing capacity denotes the maximum amount of mortgage that can be granted. We propose to prescribe that, for all other consumers, the amount of a mortgage cannot be above their individual borrowing capacity.
- 4.81 We believe that it is reasonable to require that, under no circumstances, can the amount of a mortgage be increased above a consumer's borrowing capacity. Subject to that, the decision on whether to lend and how much can be borrowed will remain with the lender and will be made in accordance with the lender's practices and conventions (for example, some lenders may reduce the amount subject to borrowers' credit status, personal circumstances, or other in-house lending restrictions, such as permissible levels of LTI or LTV).

Limitations of our approach

- 4.82 We believe that this is a necessary approach to prevent irresponsible lending and irresponsible borrowing in future. There are some limitations to this approach. Whereas a full affordability assessment can be required at the stage of a mortgage application, we have little control over consumers' debt accumulation following the mortgage approval, except where a consumer decides to remortgage with their existing first charge lender; at which point free disposable income and borrowing capacity can (and we believe should be required to) be reassessed.
- 4.83 While income is usually easy to verify, checking expenditure data is not as straightforward. Various pieces of research show that consumers tend to underestimate their spending. Consumers also fail to incorporate past experiences into their budgeting

38 Low borrowing capacity means that the mortgage sum that a consumer can afford is below the lender's set minimum for a mortgage product.

predictions³⁹ and are quite insensitive to contingencies as they fail to spontaneously include them in their estimates.⁴⁰ Where mortgage applications are concerned, (as we have seen in our discussion on non-income verified mortgages) there are also many cases where information for affordability assessments is intentionally misrepresented by consumers (and/or intermediaries) by submitting inflated incomes or deflated expenditure data. Therefore, full reliance on consumer-provided information can result in sales of unaffordable mortgages.

- 4.84 At present, lenders receive expenditure data from consumers or intermediaries and, in only some cases, verify it against publicly available data, such as ONS expenditure averages or credit reference agencies' files. Given the extent of mortgage fraud and genuine limitations of expenditure recollection, we consider expenditure verification a good practice. We believe that there is no good reason why all expenditure information should not undergo some kind of scrutiny. Some checks should be straightforward, for example, the level of existing consumer debts is available through credit reference agencies. Other expenditure, such as personal spending, is not as easy to verify. However, there are sources of data that can be used as a proxy.⁴¹
- 4.85 In some cases, the expenditure can be verified against publicly available sources (e.g. level of income tax and NI) or against documentation provided by a consumer (e.g. bank account statements; amount of utility payments by remortgagors). In other cases, the lenders will have to rely on estimates (e.g. amount of utility payments on a new house to be purchased with a mortgage) or accept consumer-provided data (e.g. food expense).
- 4.86 Some of this data can be checked against national averages, so that any non-credible outliers can be identified and investigated. In other cases, a lender may have to rely fully on information provided (or not provided) by a consumer (for example alimony payments and maintenance to ex-spouses). Even where existing credit commitments are concerned, not all data can be accessed and verified through credit reference agencies (the gaps include certain types of lenders, e.g. subprime lenders, and certain credit products, e.g. overdrafts on current accounts). While our view is that all credit information should be shared by lenders through credit reference agencies, we have not yet considered the implementation practicalities of such a recommendation.

Conclusions

- 4.87 In summary, we propose much greater prescription around affordability assessments to achieve the following outcomes:
- lenders assess consumers' borrowing capacity based on free disposable income;
 - there is no mortgage lending above consumers' borrowing capacity; and
 - lenders check that the level of expenditure declared by a consumer is plausible.

39 London School of Economics (2008), *Financial Capability - A Behavioural Economics Perspective*, CRPR 69, Report commissioned by the FSA

40 G. Ulkumen et al. (2008), *Will I Spend More in 12 Months or a Year? The Effect of Ease of Estimation and Confidence on Budget Estimates*, *Journal of Consumer Research*, Vol. 35, pp. 245-56

41 For example, ONS statistical tables on expenditure provide various population averages for different types of households, income groups and geographic areas and can be used as a proxy for checking consumer-provided information - see ONS (2008), *Family Spending: a report on the 2007 Expenditure and Food Survey*

4.88 There is of course a cost to industry that we will need to consider. But we believe this is necessary to ensure transparency and consistency of affordability assessment processes across lenders. We believe these changes will lead to a reduction in arrears and repossessions numbers as no mortgages will be sold that are unaffordable at the outset and this will reduce mortgage-related losses for lenders.

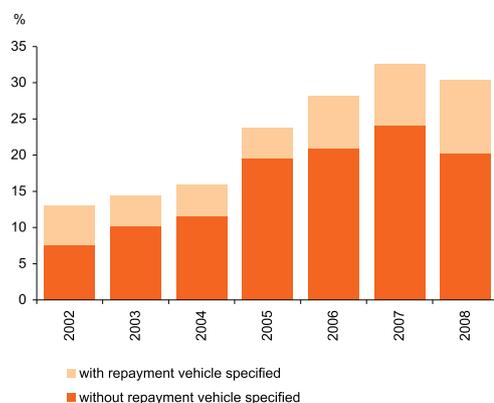
Interest-only mortgages

4.89 Interest-only mortgages are mortgages for which the borrower pays the monthly interest on the amount borrowed until the end of the mortgage period, at which point the entire capital amount that was initially borrowed is paid off. Unlike repayment mortgages, the borrower does not repay the capital over time but should have a repayment vehicle in place or some other means of repaying the capital at the end of the mortgage term. These mortgages became popular in the mid 1980's when endowment mortgages were the favoured choice of repayment. The endowment policy had to be assigned to the lender which provided a greater degree of certainty that the capital sum would be repaid.

4.90 As depicted in exhibit 4.17, in 2006/07, 33% of all residential mortgages advanced in the UK (i.e. excluding buy-to-let mortgages) were sold on an interest-only basis, up from 13% in 2002. The share is even higher in the credit-impaired segment, where 50% of mortgages advanced in 2007 are estimated to have been on an interest-only basis (data not shown). And of those 33%, the vast majority had no repayment vehicle specified.

Exhibit 4.17:

Interest-only mortgages advanced in the UK, % of total sales



Source: CML

4.91 We analysed the product sales and arrears data of more than 200 lenders and found that arrears rates increased, across the industry, with the share of interest-only products held on lenders' books, despite the fact that borrowers' monthly outgoings are significantly lower than they would be if they were on a capital repayment mortgage. We consider this to be a strong indication that many interest-only mortgages have been taken out on affordability grounds. This is confirmed by our thematic Quality of Advice work,⁴² where in many of the cases reviewed there was no clear repayment strategy identified for repayment of the capital sum.

42 For example, ONS statistical tables on expenditure provide various population averages for different types of households, income groups and geographic areas and can be used as a proxy for checking consumer-provided information - see ONS (2009), *Family Spending and Family Expenditure Survey 1997-2007*

- 4.92 Our current regulation of interest-only mortgages does not differ substantially from repayment mortgages. Prudential requirements do not differentiate between repayment and interest-only products. The sale of interest-only mortgages, in turn, is not subjected to any more stringent rules with regard to affordability assessments. Our current rules require that lenders take account of the cost of any associated repayment vehicle and, if no such repayment vehicle is specified, ‘may’ base their calculations on an equivalent repayment mortgage.
- 4.93 To ensure the affordability of interest-only mortgages, and to avoid the gaming of our tightened regulatory framework, we propose to require that lenders assess affordability of interest-only mortgages on a capital repayment basis.⁴³

- Q9: Do you agree with our proposal to require lenders to assess affordability based on;
- (i) the borrowers free disposable income;
 - (ii) a consumers borrowing capacity;
 - (iii) the plausibility of the information obtained; and
 - (iv) a capital repayment basis?
- Q10: Is the increased focus on affordability the right way to ensure sustainability of lending and consumer protection?
- Q11: Are there any additional policy levers we should use to curtail income inflation and related mortgage fraud?

Equity withdrawal

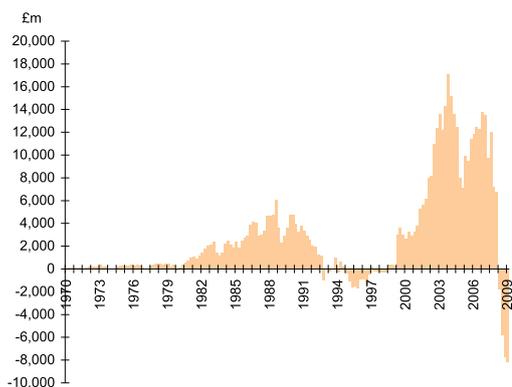
- 4.94 Traditionally, mortgages have provided the leverage people needed to buy property. However, recent years have witnessed the rapid innovation of increasingly flexible mortgages that, within certain limits, allow borrowers to spend their housing wealth through equity withdrawal.
- 4.95 Equity withdrawal is new borrowing secured on dwellings that is not invested in the housing market through house purchase or home improvements.⁴⁴ It represents additional funds available for reinvestment, consumption spending, or to pay off debt. During the period 2000 to 2007 equity withdrawals in the UK totalled £315bn (see exhibit 4.18). By the end of that period, home purchase equity withdrawal replaced home purchase as the main purpose of mortgage borrowing: 39% of all mortgages sold in 2007 were advanced for this purpose.

43 This is not intended to apply to Equity Release products nor to individual situations where a lender chooses to show temporary forbearance.

44 Bank of England definition, available at www.bankofengland.co.uk/mfsd/iadb/notesiadb/hew_notes.htm

Exhibit 4.18:

UK housing equity withdrawal, 1970 – March 2009



Source: BoE

- 4.96 While there is no reason to suspect that equity withdrawal in itself is a problem, we are assessing the extent to which these market development create issues that require changes to the FSA's regulatory approach.
- 4.97 Our analysis is at a very early stage but suggests that equity withdrawal conceals, and potentially exacerbates, consumers' affordability problems, because the extracted equity might be used to repay outstanding mortgage debt, which will result in mortgage repayments that will be inevitably higher and thus even less affordable than the previous mortgage. External analysts consider the arrears performance of remortgages with equity withdrawal to be consistently worse than home purchases.⁴⁵ Our analysis is at a very early stage but one solution may be to limit the amount of equity a consumer can withdraw.

Q12: Do you think that the FSA should limit the amount of equity a consumer can withdraw from their home?

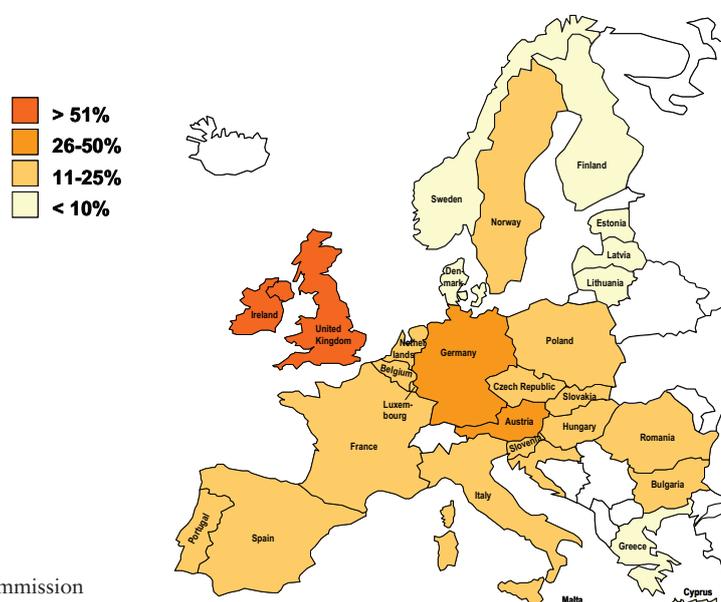
45 Moody's (2009), What drives UK mortgages to default.

5 Distribution and advice

- 5.1 The focus of our proposals for constraining irresponsible lending is on lenders. After all, it is the lenders who create and sell the products. But distribution, and in particular the intermediary distribution channel, has become a significant part of the UK mortgage market and we cannot ignore their role in our discussion on regulatory reform.
- 5.2 The significance of mortgage intermediaries as a distribution channel in the UK sets our mortgage market apart from many other countries (exhibit 5.1).

Exhibit 5.1:

Intermediary share in the EU mortgage credit market, 2007, % of sales



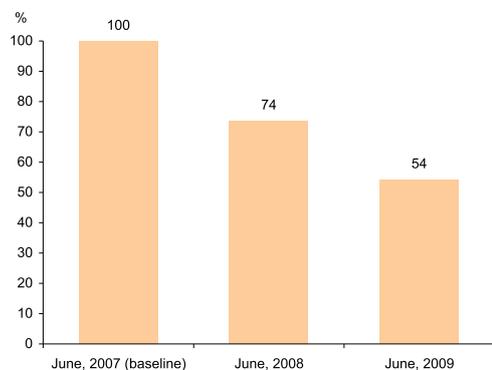
Source: European Commission

- 5.3 In comparison to Europe, the UK already has significant explicit statutory regulation for residential mortgage intermediaries.⁴⁶ Internationally, there is a trend of increasing regulatory oversight and several countries have recently introduced or are introducing stronger regulatory measures for mortgage intermediaries (including Australia, the Netherlands and Canada).

⁴⁶ European Commission (2009), *Study on Credit Intermediaries in the Internal Market*, pp 71-2, http://ec.europa.eu/internal_market/finservices-retail/docs/credit/credit_intermediaries_report_en.pdf,

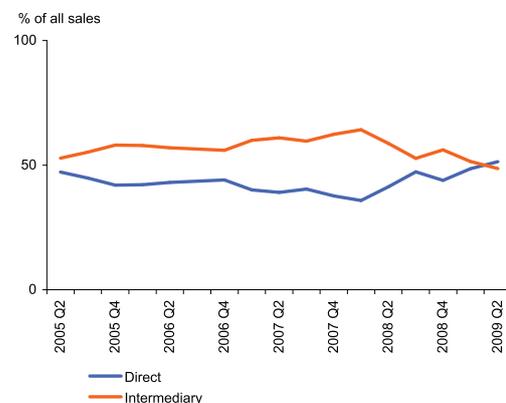
- 5.4 The UK saw very significant growth in intermediated lending in parallel to the growth in our mortgage and housing markets. In 2000, intermediaries originated 35% of total lending.⁴⁷ In 2008/09, 55% of mortgage sales were being sold through intermediaries.⁴⁸ Before the recent stall in lending, this figure was even higher in specialist areas of the market, with, for example, around 80% of credit-impaired sales going through intermediaries.⁴⁹
- 5.5 One development underlying the rise of the mortgage intermediary channel was that product diversity increased significantly in the UK before the credit crunch. Intermediaries could therefore, increasingly add value to borrowers by searching the market and providing tailored information on the mortgage products available. Another development was that a significant portion of new products were introduced by firms with little or no branch networks (specialist and non-bank lenders). These firms relied heavily on intermediaries to distribute products and find consumers.
- 5.6 Since the downturn, the number of intermediaries has significantly contracted, with many firms being forced to exit. Between June 2007 and June 2009, the number of intermediaries selling mortgages halved (exhibit 5.2).⁵⁰ In June 2009, more people bought their mortgages direct than through intermediaries for the first time in a very long time (exhibit 5.3).

Exhibit 5.2:
Number of intermediaries, June 2009 & 2008 compared with pre-crisis June 2007



Source: FSA PSD

Exhibit 5.3:
Channel of sales: proportion of regulated mortgage sales



Source: FSA PSD

- 5.7 In this chapter we discuss several regulatory changes we propose with regard to distribution and advice, including our Approved Persons regime; suitability letters; and affordability assessments, among others. We also considered whether we should increase our capital resource requirements for mortgage intermediaries, but concluded that the issues in the mortgage market differ from those in other markets and that there is therefore little rationale for doing so.

47 Mintel (2002)

48 FSA Product Sales Data for April 2008 – March 2009. www.fsa.gov.uk/pubs/other/mortgage_report_09%20final.pdf

49 In 2007, 82% of credit-impaired sales were intermediated and 61% of all sales were intermediated, FSA Product Sales Data.

50 FSA Product Sales Data

Advice and selling standards

Selling standards: information-only sales

- 5.8 Our current regulatory regime distinguishes between those sales which are conducted on an ‘advised’ basis and those which are conducted on a ‘non-advised’, or ‘information-only’ basis. An advised sale, as defined by the Regulated Activities Order⁵¹ is where a recommendation is made to a consumer to take out a particular mortgage product, whereas in a non-advised sale, information only is provided to the consumer and they are left to make their own choice.
- 5.9 We have considerable evidence that the distinction between advised and non-advised sales is not recognised or valued by consumers who:
- assume that in a regulated market no firm will identify options that aren’t broadly suitable for them;
 - believe anyway that the final purchasing decision is one for them; and
 - see intermediaries more as a means of accessing available products than as a provider of a standalone advice service.
- 5.10 Despite this, there are a significant number of firms carrying on business on a non-advised basis. In 2008, over 10,000 small firms conducted a degree of non-advised selling.⁵² Non-advised sales (by both lenders and intermediaries) constituted 33% of the number of mortgage sales.⁵⁴
- 5.11 We have considered whether, given that around a third of sales in the market are conducted on a non-advised basis and given the lesser protections afforded to those consumers, changes are needed to our current regulatory approach to advised and non-advised sales.
- 5.12 As consumers do not recognise the distinction, there is a risk that they may be heavily influenced by a firm in a non-advised sale and rely on this to their detriment. We have evidence from our thematic work that, in the intermediary market, some of the poorest practices and highest fees are exhibited by firms who do not give advice.
- 5.13 Moreover, while those consumers seeking advice will have a full suitability assessment, including affordability checks, under a non-advised sale, other than a very high-level requirement that a firm must not sell a mortgage that is inappropriate for the consumer; there are no checks on the suitability of the product. This means that in a third of mortgage sales, there are no checks to ensure that the consumer can afford the product choice and no checks to ensure that their choice is appropriate given their needs and circumstances.
- 5.14 We also have anecdotal evidence that some firms switch consumers from an advised to a non-advised sales process to take advantage of the less onerous regulatory requirements and to take advantage of the fact that, in a non-advised sale, consumers have limited recourse to the Financial Ombudsman Service.

51 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

52 Product Sales Data (PSD) in 2008 showed 10,845 small firms reported conducting a degree of non-advised sales.

53 FSA Product Sales Data

- 5.15 One option would be to move to a fully advised market where firms would be required to make a product recommendation and consequently provide advice, to every consumer. However, this approach would have significant cost implications for the industry. Moreover a substantial proportion of consumers appear to want a non-advised service and we believe that it would be wrong to force all consumers down an advised route.
- 5.16 In our view, the more proportionate approach would be to retain the existing distinction but enhance the protections consumers have in a non-advised sale by imposing a basic standardised affordability and appropriateness test. This would address the most significant areas of consumer detriment, while not forcing consumers who are sufficiently financially knowledgeable, to take ‘advice’.

Q13: Do you agree that we need to strengthen the selling standards for non-advised (information-only) sales to ensure consumers are only entering into contracts which are both affordable and appropriate?

Selling standards: advised sales

- 5.17 Mortgage advice (where a recommendation is made to take out a particular mortgage) is a significant feature of the current market. According to our product sales data (PSD), 70% of sales were advised in 2007/08. Where the sale involved an intermediary, the level of advice was even higher (91% of all intermediary mortgage sales were advised).
- 5.18 Given the volume of advised sales, we have considered whether the current regime is delivering adequate consumer protection or whether there is also a need to tighten our requirements around advised sales. Our analysis suggests that the existing suitability requirements are enough to address the main sources of detriment and have shown themselves to be enforceable. That said, our experience in operating the existing rules, has identified some potential enhancements to the suitability requirements, for example:
- affordability assessments are made on current interest rates, with consumers and advisers focusing on initial affordability only, assuming there will always be attractive remortgaging options. We believe that stress testing should be introduced to reflect a possible upward movement in rates and to focus on the long-term affordability of the current product;
 - related to this, consumers fail to give adequate attention to the risks and features of a product. Disclosure was designed to draw attention to the risks and features of a product to help consumers make informed choices. As we shall see, however, disclosure has failed to achieve this outcome. To address this, we could refocus the existing sales rules so that they are based around an explanation (similar to the ‘duty to explain’ requirements in the Consumer Credit Directive) rather than on the current process which is focused on fact finding;

- failure to take into account likely income falls, particularly when lending into retirement. This is an existing requirement in our mortgage rules that we believe needs to be bolstered by, for example, specific rules around lending into retirement, including a particular warning statement about this; and
- niche products being sold beyond the target audience. There is an existing requirement for sales to be appropriate for the consumer. This could be bolstered through a specific requirement that the recommendation must reflect both the consumer's circumstances and the intended audience for the product (for example, a product designed for the credit-impaired should not be offered to a prime consumer).

Q14: What measures should the FSA take to ensure sales standards in advised sales meet the needs of the market and appropriately protect consumers?

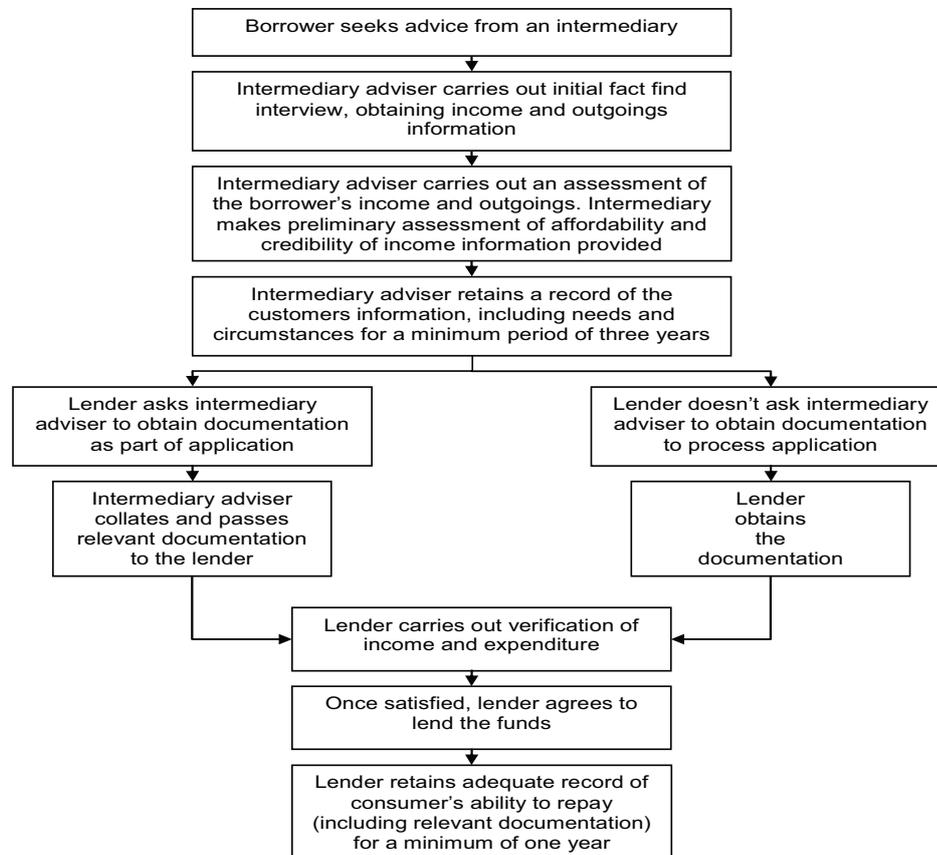
Intermediary affordability assessments for advised sales

- 5.19 As we have seen we are proposing that the lender should bear ultimate responsibility for assessing and verifying affordability in every sale. This aims to remove any uncertainty about the respective responsibilities of lenders and intermediaries.
- 5.20 Currently, the mortgage rulebook contains detailed requirements for affordability assessments by intermediaries in advised sales. If the lender will always be undertaking a detailed affordability assessment, the question arises – why require an adviser to do the same? We could remove the requirement for intermediaries to carry out an affordability assessment in any form, but we feel that an intermediary could not properly ascertain the suitability of a mortgage without first assessing a borrower's affordability. Moreover, intermediaries are often the preferred face-to-face contact for many borrowers so are best placed to obtain information about a consumer's spending, outgoings and income, including gathering the supporting documentary evidence.
- 5.21 Duplicating the proposed enhanced requirements would simply defeat the purpose of the change in the first place. So we consider the best option is to require intermediaries to continue undertaking a preliminary assessment of affordability, leaving the lender undertaking the final assessment. Intermediaries do not have access to the range of information available to lenders (such as credit scoring) and so should only undertake a preliminary assessment. Whilst we understand that intermediaries will need, at point of sale, to have some certainty about whether the lender will agree the mortgage the final lending decision must remain with the lender.
- 5.22 We propose that this preliminary assessment will continue to be on the basis of the existing standards set out in our mortgage rules but will include a number of potential enhancements, as set out in the previous section. We shall be setting up industry working groups to discuss and help determine what affordability assessments should look like for both intermediaries and lenders.

5.23 Exhibit 5.4 sets out how we expect the balance of responsibilities to work in practice.

Exhibit 5.4:

Balance of responsibilities between lenders and intermediaries for affordability assessments



Q15: To what extent should intermediaries retain responsibility for assessing a consumer's ability to repay? How could this work in practice?

Suitability letters

5.24 Once a recommendation has been made to a consumer, intermediaries are required to retain a record of the consumer's needs and circumstances and explain why a particular personal recommendation was given.⁵⁴

5.25 Our thematic reviews indicate that compliance with this record keeping requirement is low, particularly amongst small firms. One option for addressing this would be to reintroduce suitability letters, or 'product confirmations'. These were a feature of the market before statutory regulation but were replaced by FSA prescribed disclosure documents. Anecdotal evidence suggests that a considerable number of advisers still give clients suitability letters and this approach would align the mortgage market more closely with the approach in the investment and insurance markets.

54 MCOB 4.7.17R

- 5.26 There are a number of ways in which suitability letters might help achieve better outcomes:
- they are more likely to be retained than an internal record to protect firms against subsequent claims. Even if firms fail to keep a record of the letters, consumers are likely to retain copies which should increase the chances of gaining access to them;
 - they may help improve the quality of advice. Having to keep a record of the suitability of the product might provide advisers who do not currently fully comply with suitability requirements with an incentive to do so. Also, having to set out the suitability argument out in writing, including explanations why alternative options were not recommended, might be a good discipline and help increase the quality of advice; and
 - they could prompt consumers to shop around. And in subsequent years if a consumer wants to seek redress, they will have written evidence and won't face the prospect of having to argue word against word on the basis of recollection.
- 5.27 Balanced against these arguments is the fact that past experience has shown that disclosure has not been particularly effective in changing consumer behaviour. We also know that consumers generally trust advisers and therefore might not be inclined to read the suitability letter with a critical mind. There is also a risk that suitability letters might be too general, unclear or even misleading to enable the consumer to understand and review suitability.
- 5.28 On balance, our view is that introducing suitability letters will achieve better outcomes for both firms and consumers.

Q16: Do you agree that suitability letters should be introduced as a compulsory standard?

Extending the Approved Persons regime

- 5.29 There are certain functions (Controlled Functions) within a firm that we consider to be of sufficient importance that the individuals carrying out those functions need to be 'Approved Persons', that is assessed by us as 'fit and proper' before they can carry them out. Once approved, an Approved Person must continue to comply with the Fit and Proper test for Approved Persons⁵⁵ and the Statements of Principle for Approved Persons.⁵⁶
- 5.30 Controlled Functions are those jobs or responsibilities within a business that have a particular regulatory significance. Currently for mortgage and other home finance firms the only relevant controlled functions are some of the 'significant influence' functions i.e. those individuals who exercise significant influence over

55 Part of the High Level standards in the FSA Handbook, the *Fit and Proper test for Approved Persons* sets out the minimum standards for becoming and remaining an approved person.

56 Also part of the High Level Standards in the FSA Handbook, the *Statements of Principle and Code of Practice for Approved Persons* sets out the fundamental obligations of approved persons.

the firm.⁵⁷ We are proposing to extend the Approved Persons regime (through the application of CF30 (consumer function) and CF10 (compliance oversight) to mortgage (and other home finance) advisers and/or arrangers (specifically to those who are ‘bringing about’ a home finance activity).

- 5.31 Though the Approved Persons regime applies to mortgage and other home finance firms, and provides for senior management accountability within these firms through the application of the ‘significant influence’ functions. However, individual mortgage advisers are currently exempt from the regime as the consumer function does not extend to the provision of mortgage advice.
- 5.32 Much of the benefit recently attributed to the possible application of the consumer function to mortgage advisers comes from the risk they are seen to present to our financial crime objective. Historically, the decision not to apply the consumer function to mortgage advisers was not linked to financial crime. Rather, the risks of financial crime were identified as relating primarily to money laundering and documentation fraud. In this context it was agreed that these risks were most appropriately mitigated through the application of the Money Laundering sourcebook and the requirement that firms employ honest and competent individuals (SYSC 3.2.13) respectively.
- 5.33 Financial crime in the mortgage market is now a major issue. Recent research by the Association of Chief Police Officers (ACPO), led by the City of London Police (CoLP), has indicated extensive organised crime involvement in property and mortgage fraud.⁵⁸ The report confirmed mortgage fraud of around £700 million, operating at a scale that suggests that even a small percentage reduction in such fraud would carry a significant financial benefit.
- 5.34 Evidence and analysis gathered as part of our review also found evidence of unsuitable mortgage recommendations and those mortgage intermediaries responsible for this moving between firms undetected. The ability to take action against individuals and withdraw approved status, censure them publicly and impose financial penalties is likely to significantly enhance deterrence. This should lead to higher standards across the industry and ultimately an increase in the quality of mortgage advice.
- 5.35 Consistent with our strengthening of our supervisory approach overall, extending the compliance oversight function would reinforce senior management responsibility for compliance and, in particular, compliance with the systems and controls underpinning the monitoring and assessment of their employees’ fitness and propriety.
- 5.36 So, overall, the proposed extension of the Approved Persons regime should bring a number of benefits, including:
- improving standards of fitness and propriety among individual mortgage advisers;
 - prohibiting rogue individuals from the industry; and
 - where they do enter the industry, making them accountable for the advice they provide;

57 See the Supervision manual of the FSA Handbook, SUP 10.9 (Significant Management functions).

58 ACPO (2008), Police committed to tackling mortgage fraud, press release on March 5

- limiting the movement of problematic individuals through the industry; and
 - less fraud leading to a cleaner market.
- 5.37 These proposals are likely to carry significant costs, in the form of a one-off cost to the industry from new individuals being required to apply for Approved Person's status, coupled with resource and implementation costs for the FSA. But we see these costs as proportionate based on the benefit, which can be realised through the potential to reduce our risk and exposure to financial crime and in turn, of an overall increase and confidence in the financial system.

Q17: What are the implications of applying the Approved Person's regime to all individual mortgage intermediaries?

Retail Distribution Review (RDR) read across

- 5.38 We noted in our RDR Feedback Statement⁵⁹ that we were undertaking a thorough review of our mortgage regime and that our analysis so far had not identified a need to apply a RDR approach to mortgage distribution. However, we also noted that should further analysis show this approach would be useful, we would review these findings.
- 5.39 Given the number of firms that operate across both the investment and mortgage markets (estimated to be approximately 58% of directly authorised investment intermediaries or 3,159 firms⁶⁰), there has been a natural presumption to read-across the RDR. It is argued that inconsistent regulation of mortgage and retail investment markets could create regulatory complexity for firms operating across both markets. There is also a concern that rogue firms will look to move out of retail investment into the mortgage market if it is more lightly regulated.
- 5.40 But, while we recognise these issues, we do not see these as reasons in themselves to read-across the RDR. Our analysis has not identified a need to apply a RDR approach to mortgage distribution. It suggests that the problems in the mortgage market have some different underlying drivers and our key priority is to effectively address the issues in the mortgage market before we look to read-across a solution that was developed with a different market in mind.

Remuneration

- 5.41 Transferring the RDR proposal on 'adviser charging' to the mortgage market would mean that lenders would no longer set adviser remuneration and that adviser firms would set their own charges. In practice, this would be likely to facilitate a fee-based market but consumers would still be able to 'roll-up' the adviser fee into the loan (though we discuss the continuation of this practice further in Chapter 8). Our comparative analysis has not identified any other countries which prohibit commission payments in mortgage markets.

59 www.fsa.gov.uk/pubs/discussion/fs08_06.pdf

60 FSA Register of directly authorised firms (excluding appointed representatives) as at March 2009

- 5.42 We have not seen the problems in the mortgage market that underpinned the RDR for the investment market. Although we have seen some issues around quantity over quality in the more niche, credit-impaired segments of the market, the problem does not seem to be of the same extent as seen in the investment market. Evidence to date has not suggested the current remuneration model (and commission bias) is causing the same degree of consumer harm or needs the same regulatory response. While the wrong mortgage may be bought, the mortgage market is characterised by a relatively high level of switching and consumers have (until the recent contraction in the market) been able to easily switch out of bad product choices.
- 5.43 There is scope for product and provider bias – we see lenders actively manage demand (both up and down) by adjusting commissions. But net commission rates within the prime mainstream market are flat – typically 0.31 – 0.35% of the loan. Product bias issues are most likely to occur in niche market segments (self-cert and credit-impaired), where commissions have been higher. Commissions for self-cert loans have typically been around 0.5% of the loan. Commissions for credit-impaired (in the industry more loosely referred to as ‘subprime’) have typically been around 0.5 – 1% of the loan depending on whether the loan is ‘light’ or ‘heavy adverse subprime’, although there have been instances of some niche lenders paying substantially higher commission.
- 5.44 We are proposing to address mis-selling of self-cert products by requiring income verification. As a result of this there will be no need for further action to address potential product bias issues underlying mis-selling of self-cert products.
- 5.45 Regarding potential product bias issues in the credit-impaired sector, evidence suggests that these products were only rarely mis-sold to prime consumers. Thematic work found that in 94% of the cases reviewed, consumers would not have been eligible for prime loans.⁶¹ However, there is scope for commissions to incentivise firms to sell a credit-impaired consumer a heavier adverse product than they need.
- 5.46 Therefore we consider that product bias issues have mainly occurred in a small part of the market – within the credit-impaired segment. In the peak years, external estimates of what has been referred to as ‘subprime’ lending volumes vary between 4% and 7% of total in the peak years (2005 – 2006). If we were to read across adviser charging, we would potentially impose significant costs on the mainstream market to address issues in niche market segments only.
- 5.47 In view of this we have considered whether we could just apply adviser charging to niche segments of the market such as credit-impaired. However, there is a significant risk that intermediary fees in the impaired credit sector would remain significantly higher than prime commission rates. So there would still be an incentive for intermediaries to mis-sell impaired credit products and the underlying product bias issues may remain. Credit-impaired consumers’ desire to access a mortgage gives intermediaries a degree of market power in setting fees. We are also reluctant to create a different set of regulatory standards just for the impaired credit sector, which would be difficult to define and could readily be ‘gamed’.

61 FSA (2007), Thematic review into subprime mortgage lending, <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml>:

- 5.48 Our current view is that we could resolve problems in the niche segments simply by targeting our regulatory action higher up the value chain at the lenders and their products, as discussed previously. We think that it is sufficient to address the incentives of lenders to lend responsibly and to restrict mortgage products which create material risks to our statutory objectives. We can also address the problems through credible supervision of our existing advice standards: the mortgage rules require advisers to recommend a suitable and affordable mortgage, regardless of the commission they receive.
- 5.49 There is some evidence to suggest commissions are incentivising churning and that volume-based commissions incentivise intermediaries to recommend that people take out more mortgage credit than they need. The UK saw very significant growth in mortgage credit so we are still considering whether we need to do more to address potential issues around volume-based commissions. However, we do not believe that a read-across of adviser charging would address this issue or churning issues. A straight read-across of adviser charging would not restrict volume-based commissions and so could have little impact on the incentive to recommend that consumers take on more credit than they need. Additionally, we expect that most intermediaries would still be likely to charge fees contingent on a sale under adviser charging. So there will still be a significant incentive to churn.

Q18: Do you agree with our conclusion not to read across the adviser charging element of the RDR proposals into the mortgage market?

Q19: Are there any other considerations that are relevant to the assessment of the issues and risks posed by the current remuneration model within the mortgage market, which are not identified within the DP?

Professionalism

- 5.50 We also don't see a strong case for reading across the Professional Standards Board. There are three reasons underlying this.
- 5.51 First, we have found no evidence to suggest lack of training and competence is a significant issue in the mortgage market. Previous thematic reviews have indicated that although a high percentage of firms' Training and Competence (T&C) measures fall short of the required standards, the issues uncovered were process-driven rather than quality or standard issues which would ultimately result in consumer detriment.⁵⁸ This is further supported by the few enforcement cases being brought against firms specifically for T&C breaches.
- 5.52 Second, in terms of the level of competence required by advisers, the mortgage market is much simpler than the market for retail investments. The characteristics of mortgages can be compared in advance and do not rely to the same degree on inherently uncertain judgements about the relative rates of return and risks from investing in different assets.

5.53 Finally, as we discussed above, we are proposing to extend the Approved Persons regime to mortgage intermediaries so that they will be registered with the FSA. This proposal is expected to have a positive impact on the professional standards in the industry.

5.54 However, we do recognise some merits in reading across elements of the professional standards work stream of the RDR. Principally, the individual registration of advisers by the PSB – which would provide a public record of all authorised mortgage intermediaries – would limit the ability of individuals to ‘hide’ from regulatory penalties. It would also give us the ability to ‘track’ individuals throughout the industry. We also see merit in applying of a code of ethics, and also firm-led initiatives on continuing professional development. Our views on these issues will depend on the shape decided for the PSB later this year.

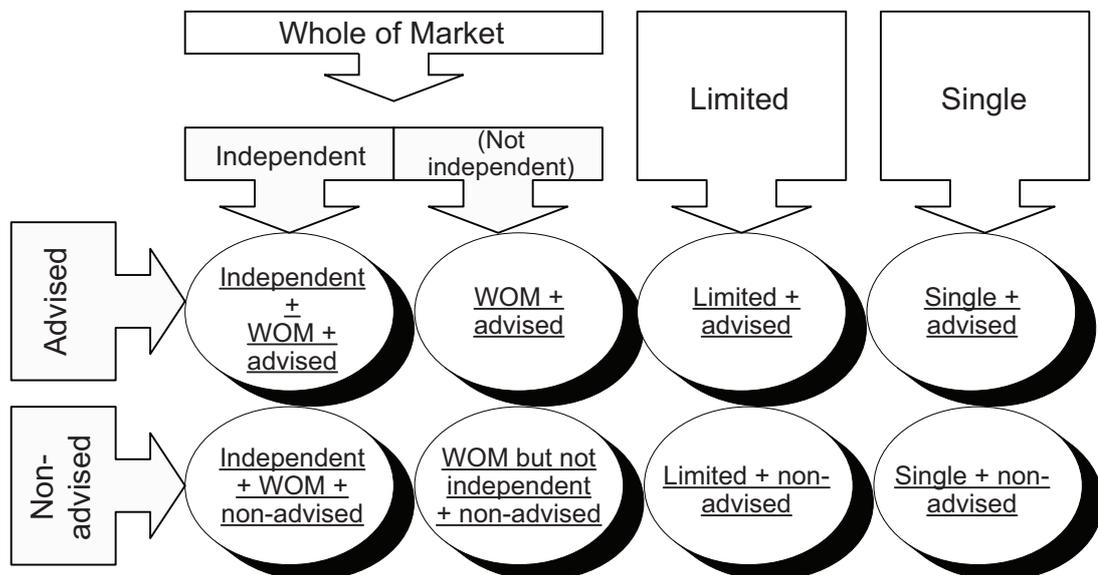
Q20: To what extent should the proposals for a PSB as outlined in the RDR be extended to the mortgage market?

Scope of service labelling

5.55 Currently there are a variety of intermediary service labels that ostensibly aim to clarify for consumers the service an intermediary will offer them (see exhibit 5.4). These include ‘independent’, ‘limited’, ‘single’, or ‘whole of market’. Some of these service labels and descriptions can also interact across the advised / non-advised spectrum, which creates an additional layer of complexity for the consumer. Consumers simply do not understand these various types of services, which has led us to consider the case for simplification.

Exhibit 5.4:

Current regulatory landscape of distribution



- 5.56 The Retail Distribution Review aims to bring about a simpler and clearer explanation of the distribution landscape in the retail investment market and we believe that it makes sense for us to adopt a similar approach for the mortgage market.
- 5.57 We therefore propose that we should replace the existing ‘whole of market’, ‘independent’ and ‘single’ labels, with the much simpler and readily understandable ‘independent’ (whole of market) and ‘restricted’ (limited panel) advice only. For similar reasons, we propose to replace ‘non-advised’ with ‘information-only’.

Q21: Do you agree that simplified scope of service labelling, limited to ‘independent’ or ‘restricted advice’ and also describing a non-advised service as ‘information-only’, will result in better consumer understanding of the services on offer?

6 Disclosure and changing consumer behaviour

Reform of disclosure

- 6.1 In a market that appeared broadly competitive, disclosure of key pieces of information about the service a consumer should expect (through the Initial Disclosure Document [IDD]) and about the mortgage product being offered to them (through the Key Facts Illustration [KFI]) was the cornerstone of our mortgage regime. Disclosure was intended to enable consumers to shop around and compare the services and products on offer from different firms, and to help them make better informed choices. However, the evidence suggests that few consumers are using the prescribed documentation in the way we intended. Similar problems about using disclosure as a regulatory tool have been experienced in the investment and insurance market.
- 6.2 In both the investment and insurance markets we have moved to a policy position where the focus is on early disclosure of key information rather than the prescription of the form of that information. The mortgage regime is the only market in which the IDD has remained a component of regulatory disclosure.
- 6.3 Research evidence⁶² shows that the IDD has in fact had very little impact on consumer behaviour. Although created to provide consumers with the information required to compare the different fees, charges and services provided by firms, in reality consumers are more likely to choose a firm based on personal recommendation or past experience. Evidence also shows that consumers have a low recall of the document and rely much more on what they are told during the discussions.
- 6.4 We propose to move to the approach of the investment and insurance markets and to remove the requirement for the IDD. We know that firms typically provide terms of business disclosure, usually in letter form. Being both personalised and ‘free text’ this could well be a better means of disclosing fees information and information about the level of service on offer than the IDD.
- 6.5 The KFI by contrast, has been well received by consumers, although as a record of their purchasing decision rather than a shopping around tool. We believe that we should retain the KFI given the significant set-up costs and the consistent message from research that the KFI is liked and used by consumers (although only a small

62 www.fsa.gov.uk/pubs/consumer_research/crpr81.pdf

number of more savvy consumers use it to shop around). We are also conscious that the European Commission is currently assessing the role of mortgage disclosure and may bring forward proposals in the short to medium term.

- 6.6 We are also considering whether to require oral disclosure, which the evidence seems to suggest could be a more effective way of getting key pieces of information across to the consumer. Oral disclosure was introduced as part of the reforms of the insurance regulatory regime. Analysis of the impact of oral disclosure for the insurance market is currently underway and the outcomes from that work will help inform our approach.

Q22: Do you agree with the proposals to;

- (i) remove the requirement for the IDD and replace with disclosure of key messages;
- (ii) retain use of the KFI; and
- (iii) require elements of disclosure to be carried out on an oral basis?

Changing consumer behaviour

- 6.7 Fundamental to our approach to disclosure was the view that consumers are rational market participants. So, when given relevant information – presented in a clear and meaningful manner – the assumption was that consumers would use this as a basis for any purchasing decision.
- 6.8 In practice, the mis-buying we have seen in the mortgage market provides clear evidence that some consumers are failing to engage in this way. It also bears out the wider point *The Turner Review* has made regarding the limits on consumer behaviour in its questioning of past regulatory assumptions about the rationality of markets.
- 6.9 There are also strong grounds for distinguishing mortgage purchasing behaviours from the behaviours we might expect for other retail financial services transactions. In particular:
- Mortgage borrowers are typically motivated by an immediate want or need. This could be linked directly to the product, for example in the case of a debt consolidation loan providing the funds to pay off other obligations. But in many cases the mortgage is simply the means by which the consumer can get the desired home, car or holiday – with the consumer focusing much more strongly on the end result. While investment and insurance products are commonly ‘sold’, the want or need for the funds or the goods they will buy means that many mortgages are ‘bought’.
 - Mortgage consumers receive considerable sums of money upfront for a relatively small initial payment, and market practices have evolved such that even fees normally payable upfront can be added to the loan.

- 6.10 Both factors are likely to lessen consumer caution and questioning behaviours, and generate a difference in the steps a consumer takes to protect their own interests. This is not to say that all consumers have acted irresponsibly. The mortgage market has worked well for many. But for a significant number of others, the outcome has not been as good.
- 6.11 The problems are such that we doubt whether greater transparency or financial capability (in the shorter term) will provide an answer. For example, it seems unlikely that a lack of financial skills was behind the widespread overstating of income found in self-certification mortgage applications.
- 6.12 As a result, an emerging part of our policy development has been an approach that aims to protect consumers more from themselves. In practice, this means curbing some sales that previously both consumers and lenders were happy to enter into, such as the ban of self-certification, as well as proposed action on prohibiting sales to consumers exhibiting multiple high-risk characteristics (discussed earlier in Chapter 4). In prescribing what an affordability assessment should be, we are increasing firms' responsibilities, in part to address the potential we see for mis-buying by consumers. But we also see one benefit of this approach is that it may encourage consumers to consider their ability to service loans more carefully.
- 6.13 The greater intervention proposed is not a substitute for consumers fully engaging with their options and making rational purchasing decisions. We are recognising that mis-buying has contributed to the problems and that it is unrealistic to expect behavioural change alone to put things right. Our more interventionist proposals are specific to the issues we see in the mortgage market as opposed to others we regulate. This is consistent with how the Financial Services and Markets Act 2000 recognises that an appropriate degree of consumer protection should have regard to the nature of the risks, experience and expertise involved.
- 6.14 Within the market there has been a long-standing debate and disagreement about what forms an appropriate level of consumer protection, and precisely where the balance of obligations between firms and consumers lies.⁶³ This viewpoint, and a National Audit Office recommendation⁶⁴ that we identify the responsibilities that we want consumers to take on, led us to publish a DP on consumer responsibility last December.⁶⁵ We have just published our Feedback Statement on this topic.⁶⁶
- 6.15 We are not reopening the debate about the appropriate balance of responsibilities. We continue to believe that helping consumers to understand their current responsibilities,

63 The concept of consumers having 'responsibilities' or 'obligations' is itself disputed. Some recognise only that there may be circumstances (such as recklessness, carelessness or a failure to take reasonable steps to mitigate a loss) that the courts might consider when determining the consumer's right to compensation. Accordingly, the references here to 'responsibilities' or 'obligations' should be understood as meaning simply the actions that a consumer might be expected to take to protect their own interests.

64 *The Financial Services Authority: A Review under Section 12 of the Financial Services and Markets Act 2000. National Audit Office. April 2007.*

65 *DP 08/5 – Consumer responsibility.* FSA. December 2008. Work on both principles-based regulation (PBR) and the RDR were further drivers for the publication of the Discussion Paper, on which the current intention is to publish a Feedback Statement in September 2009.

66 www.fsa.gov.uk/pubs/discussion/fs09_02.pdf

as well as what they can do to protect their own best interests, is both helpful and consistent with our statutory objectives and we will take this forward through our financial capability agenda and our wider communications strategy.

Q23: Do you agree that the limitations on the rationality of consumer behaviour in the mortgage market support the case for greater regulatory intrusion?

Q24: Do you agree that the FSA has a role in preventing the extension of credit to individuals who are unable to afford such high levels of debt?

Financial capability

- 6.16 Our financial capability programme is working towards a vision of better informed, educated and more confident consumers, who are able to take greater responsibility for their financial affairs and play a more active role in the market for financial services. The FSA has a commitment through the National Strategy for Financial Capability to inform, educate and guide consumers with a view to helping them achieve positive outcomes in their interaction with firms.
- 6.17 The behavioural biases demonstrated by consumers and discussed in this paper have a significant impact on our financial capability work, and impose boundaries on what can be achieved by financial capability. But there is also evidence that targeted information and advice, designed to reach the right people at the right time, improves outcomes for consumers.⁶⁷ While much of our financial capability strategy is aimed at a longer term change in consumer behaviour, there is also a role for financial capability in providing support and guidance through times of difficulty.
- 6.18 The financial crisis has been the cause of major economic distress for many people. Many are in arrears and facing real problems servicing their debts. Consumers were unprepared going into the financial crisis and a cautious attitude to risk amongst most of the population was not matched by behaviour. One study estimated that only one-fifth were 'relatively secure' with appropriate insurance cover and adequate savings, without being highly exposed to stock market changes or risky borrowing. A further fifth were 'highly exposed' or 'inherently at risk', either through high levels of debt, or inadequate protection against income shocks.⁶⁸
- 6.19 We already have a wide range of resources to improve financial capability that are relevant to current or prospective mortgage consumers. In addition to these existing materials, we have identified three work streams which we believe will improve consumer outcomes and complement the overall reforms proposed for the mortgage market. All of these initiatives are designed to help consumers at a time of financial difficulty and/or vulnerability.

67 CRP 69: FSA Consumer Research Paper 69 (2008). "*Financial Capability: A behavioural Economics Perspective*", <http://www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf>

68 Atkinson and Finney, *Exposed?*, Personal Finance Research Centre, Bristol, December 2008

Money Guidance

- 6.20 The Money Guidance Pathfinder, running in partnership with government under the MoneyMadcLEAR brand, provides guidance face-to-face, by telephone and online. Money Guidance is specifically aimed at those who are ‘vulnerable to the consequences of poor financial decision-making’. The target group includes the ‘Credit Hungry Families’ with multiple high-risk characteristics who are most likely to fall into arrears.⁶⁹ Money Guidance differs from pure information provision in that it can offer a much more bespoke service to individuals, tailoring the support to their specific needs; and provides support at a time when it is in demand. The full evaluation will assess the extent to which the service has addressed the needs of these more vulnerable groups and the topics of greatest concern to them.
- 6.21 Our internal analysis from geo-demographic profiling of repossession cases sold at auction indicates that buy-to-let investors and borrowers who are over-indebted through an over reliance on credit to supplement their income, have been the main sources of the growth in mortgage repossessions so far. We therefore propose to ensure our materials set out the risks and implications of seeing property as an investment and an asset that can be used to fund day-to-day spending.

Triggers for arrears

- 6.22 To respond to consumers’ needs in the current economic climate; we have business plan commitments specifically aimed at helping people experiencing unemployment and relationship breakdown. Both increase during an economic downturn and both are known triggers for arrears and repossessions.⁷⁰ Material has already been published on www.moneymadeclear.fsa.gov.uk and we are exploring ways to reach consumers through the intermediaries they engage with during these life events. Identifying trigger points or key life events helps overcome some of the behavioural biases in consumer behaviour. At such trigger points, consumers are more open to changing behaviour, and acting on information they receive.

Court process

- 6.23 We know consumer outcomes when facing repossession are greatly enhanced where people have access to advice⁷¹, but that the majority of people do not get advice, either because it is unavailable, or because they do not know how to access it. We propose working with partners in government to assess whether access to advice can be improved at key stages before repossession occurs.⁷²

69 See www.hm-treasury.gov.uk/d/thoresen_annex7.pdf for background on the target groups.

70 Survey of English Housing, in ‘Housing market recessions and sustainable homeownership’, Joseph Rowntree Foundation, July 2008

71 Getting advice from a solicitor as part of a housing possession court duty scheme leads to immediate repossession being avoided in 85% of cases

72 This would complement funding announced by the Government: www.justice.gov.uk/news/newsrelease210409b.htm.

Q25: Do you have any comments on the financial capability initiatives designed to support the overall mortgage market reform?

7 Arrears and repossessions

- 7.1 The FSA's existing rules dealing with mortgage arrears require firms to have a written policy and procedures in place to ensure that consumers in financial difficulties are treated fairly.
- 7.2 The rules set out the factors which we consider central to such a policy and procedures. These include using reasonable efforts to reach agreement with the consumer, adopting a reasonable approach to the time over which any shortfall in payments can be made good and only taking repossession action where all other reasonable attempts to resolve the position have failed.
- 7.3 The policy aim behind our rules was twofold: to improve the information provided to consumers by setting minimum standards (for example, on the type and frequency of information to be provided); and to consolidate a number of voluntary good practice standards existing in the market at the time of the introduction of mortgage regulation. Those practice standards had been developed in response to the adverse impact of the high-levels of repossessions in the late 1990's on market and consumer confidence. The FSA thought it appropriate to require firms, at a high level, to follow rules based on those good practice standards. This was to allow firms to adopt alternative approaches that were fair and meet the reasonable needs of both the consumer and the firm, recognising that there would be cases where the consumer had no reasonable prospect of getting back on track and that dealing with the inevitable sooner rather than later was in everyone's best interests. But also that there would be cases where flexibility and forbearance would lead to much better outcomes for both the consumer and lender.
- 7.4 In response to worsening market conditions, we commissioned an urgent review of lenders' compliance with our arrears handling rules in December 2007. This work has been expanded and continues. It is clear from the outcomes of that work that our high-level approach has not sufficiently protected consumers and that this is another area where we need to take a much more robust and interventionist approach. Some of the outcomes for consumers highlighted through our thematic work have been sufficiently poor that we are taking enforcement action against a number of firms. We also believe that there is a need for us to take immediate action to strengthen our rules and propose to consult in January 2010 on the changes we believe to be necessary to ensure better outcomes for consumers.

Mortgage arrears and forbearance

- 7.5 It is clear that many firms have not exercised forbearance but moved quickly to repossess properties. We propose to consult on converting what is currently guidance on forbearance in the mortgage rulebook into binding rules. Therefore, instead of suggesting the range of tools that *could* be used to help borrowers in arrears, we will prescribe a non-exhaustive list of tools that firms *must* employ to help consumers in arrears, which will include the various government schemes put in place to help borrowers.
- 7.6 This change should help ensure that borrowers in financial difficulties are treated fairly and are offered a range of solutions to help them to manage their way out of arrears. Additionally it will also address a concern identified by our thematic work; the impact of securitisations on the treatment of customers in arrears. Although the review did not identify clear evidence of actual consumer detriment, some lenders told us that they felt constrained in the options they could offer to distressed borrowers due to restrictions set out in securitisation covenants. By making it explicit in the rules that firms must, at a minimum, be prepared to deploy a particular range of hardship tools, we shall make it much more difficult for them to conclude securitisation deals that are at odds with their duty to treat customers fairly.

Arrears charging practices

- 7.7 We have already made clear that some of the charging practices we have seen in our thematic work are unfair and unacceptable. We expect arrears charges to be a fair reflection of the additional administration costs faced by the lender, not a way to increase profits or offset costs from other parts of their business. Despite this we found evidence of lenders looking to recoup costs through arrears charges for activities that are not related to the additional cost of arrears handling. We do not expect to see costs, such as advertising, funding costs, or provisions to cover regulatory fines, for example, recovered from arrears charges.
- 7.8 We have published good and poor practice and have issued other material (for example speeches and press releases) designed to help clarify the standards we expect of firms. In four of the cases referred to enforcement following our thematic work, breaches of our rules on charges are part of the case against all four firms.
- 7.9 In view of the obvious unfairness of some of the charges imposed by a number of lenders, we propose to take immediate action and consult in January 2010 on banning the following charges:
- the continued application of a monthly arrears administration charge where a consumer is adhering to an arrangement to repay arrears. This charge often negates the benefit of any extra payments being made by the borrower and is clearly unfair and unjust; and

- the charging of Early Redemption Charges on arrears fees and charges. Where the borrower's loan amount has increased because of missed payments and the addition of fees and charges, we will propose that lenders will only be able to apply an early repayment charge to the outstanding loan.

We do not currently prescribe the level of arrears charges. As we discuss in Chapter 8, we have started a wider piece of investigatory work into the level of charges generally and we are prioritising arrears charges in that work. This will involve a detailed analysis of arrears charges in the market to establish whether they genuinely reflect underlying costs. We will also investigate the feasibility of establishing a baseline figure for arrears charges, to prevent out-of-line fees being charged. This will be the first stage of a wider piece of ongoing supervisory work into the levels of lender product charges and lender charging models.

Specialist lending risks

- 7.10 In Chapter 3, we discussed high-risk lending and the emergence of business models built around consumers who foreseeably could not pay their mortgage. In the first phase of our thematic arrears work we recognised that practices in the specialist market were poor in comparison to the mainstream market. As a result, the second phase of our work focused on specialist lenders (a number of whom had withdrawn from the market) and on the third party administrators who were responsible for managing their arrears and repossessions cases. We published the findings of our review in June 2009 and at that time announced that four firms had been referred to enforcement as a result of unfair treatment of borrowers in arrears.⁷³ Since then further investigatory work has resulted in another firm being referred for similar failings and we expect at least one more firm to be referred from the second phase of this work.

Third Party Administrators (TPAs)

- 7.11 TPAs carry on the regulated activity of 'administering'⁷⁴ and have to be authorised by us to do so. When we introduced the mortgage rules, most TPAs carried on administering activities under outsourcing arrangements with lenders where the lender would dictate the policy and process under which TPA carried out its activities. To reflect this, our rules were modified to allow TPAs to carry on their administering activities in the name of the outsourcing firm and were not required to disclose their identity to a consumer.
- 7.12 Since then, the role of TPAs has developed and it is apparent from our thematic work that TPAs now exercise significant influence over lenders in agreeing the policy and process under which they will carry on their administering activities i.e. the relationship between lender and TPA is no longer a pure outsourcing arrangement. Given the

⁷³ www.fsa.gov.uk/pages/About/what/thematic/mortgage_arrears/handling.shtml

⁷⁴ Article 61(3)(b) of the RAO defines administering a regulated mortgage contract as either or both of (1) notifying the borrower of changes in interest rates or payments due under the contract, or of other matters of which the contract requires him to be notified; and (2) taking any necessary steps for the purposes of collecting or recovering payments due under the contract from the borrower.

relatively few TPAs in the market, we are also concerned that they have developed a standardised approach to their activities, including arrears recovery, to enable them to carry on administering activities for a number of lenders. We are concerned that this may lead to a focus on meeting processing targets rather than the fair treatment of consumers.

- 7.13 We are therefore proposing to review our approach to TPAs. As part of our new interventionist supervisory approach generally, we will continue to focus on those firms whose business models and/or arrears and repossession levels are likely to indicate a high risk of unfair treatment for consumers and will take whatever steps are necessary to improve outcomes for these consumers.

Q26: Do you have any comments on our proposals to strengthen our approach to firms' arrears management practices?

8 Unfair charging practices and price regulation

Unfair charges

- 8.1 As we discussed in Chapter 7, we propose a more interventionist and robust approach to monitoring and enforcing against excessive and unfair charging practices in the mortgage market. This marks a substantial change in our approach to date, whereby we are willing to intervene into market pricing and charging practices if necessary. Although we have mortgage rules in place that prohibit excessive charging generally,⁷⁵ we have in practice preferred to rely on disclosure and transparency of charges.
- 8.2 As we have discussed already, however, disclosure and transparency have not influenced consumer purchasing behaviour as effectively as we hoped. Many consumers focus on initial payments or headline rates at the expense of other product features such as fees and charges. This is particularly the case where charges are incurred post-sale (for example, Early Repayment Charges [ERCs] and arrears charges). Consumers do not think about going into arrears when they are taking out their mortgage. And recent research found that some consumers simply do not understand when ERCs would apply.⁷⁶ So firms have a degree of market power in setting charges and have not been subject to adequate competitive constraints in this area.
- 8.3 Internal FSA research into arrangement fees for a sample of lenders found their arrangement fees had increased significantly over time. In 2002, a typical arrangement fee was around £199 – £295. By 2009, arrangement fees for the same sample of lenders ranged from £299 to £1,995.
- 8.4 Although we are concerned by the significant increases and variation in some product charges, we recognise add-on fees and charges are sometimes used to cross-subsidise a lower headline interest rate in order to attract consumers. So we do not know for sure that consumers are getting a worse deal.

75 MCOB 12.3.1 R (2) requires a firm to ensure that an ERC is a reasonable pre-estimate of the costs as a result of the consumer repaying the amount due under the regulated mortgage contract before the contract has terminated. MCOB 12.4.1 R requires a firm to ensure it does not impose a charge for arrears except where that charge is a reasonable estimate of the cost of the additional administration required as a result of the consumer being in arrears. MCOB 12.5.2 R requires a firm to ensure that its charges to a consumer in connection with the firm entering into a contract are not excessive.

76 If anything, consumers tended to feel that repaying their mortgage early was likely only to occur as a result of a windfall rather than identifying scenarios such as having to sell the house due to a loss of income or divorce. *Disclosure in the prime mortgage market* prepared for the FSA (December 2008)

- 8.5 We have work underway to help us to develop a better understanding of charging and pricing structures and to enable us to identify and challenge unfair and excessive practices. Initially we will be undertaking some further supervisory work into arrears charges. This will form the first stage of a wider piece of ongoing supervisory work into the levels of lender product charges and lender charging models.
- 8.6 Our comparative analysis shows that some countries use alternative measures to the UK to ensure that the charges imposed by lenders are reasonable. For example, Cyprus specifies how ERCs should be calculated and the fees charged cannot exceed 1.25% of the repayment, Belgium imposes a three-month interest rate cap on ERCs, and the USA prohibits pre-payment penalties in certain circumstances. Further supervisory investigation and research may suggest that approaches such as these are warranted in the UK.

Q27: Do you consider that the mortgage market fees and charges reflect the underlying costs or are consumers paying excessive charges?

Rolling up fees and charges into loans

- 8.7 Some borrowers choose to roll up intermediary fees and loan charges (such as set-up fees) into the loan. This is especially true in the credit-impaired segment of the market. Where borrowers do not have to pay fees or charges up front, they are unlikely to focus on the levels of such fees and charges and it diminishes consumer price sensitivity.
- 8.8 We are considering prohibiting the rolling up of intermediary fees and mortgage product charges into the loan. We believe such a restriction could help to strengthen consumer attention on fees and charges although we have not yet thoroughly analysed whether the case for this exists.

Q28: What would be the impact of consumers not being allowed to roll up intermediary fees and product charges into the mortgage loan?

9 Scope extensions

- 9.1 The proposals set out in this paper amount to a significant step-change in regulation. We are proposing to intervene much more directly to deliver the higher standards of lending and borrowing that we think are crucial to a sustainable market that works better for consumers.
- 9.2 Our aim is a market where low quality, unsustainable lending greatly reduces if not disappears. A key challenge to achieving this is the risk that firms and consumers may ‘game’ our changes by looking to replace the first charge credit that they can no longer access with other forms of secured credit.
- 9.3 When the government first asked us to regulate mortgages, our responsibilities were limited to residential loans secured by a first charge as they were seen to expose consumers to greater risk. Mortgages outside of this definition⁷⁷ either:
- remain regulated by the Office of Fair Trading (OFT) under the Consumer Credit Act 1974 (this is the case with loans secured by second or subsequent charge on residential property); or
 - fall outside of direct regulation, the most obvious example being buy-to-let mortgages.
- 9.4 There has been regular debate about the scope of our mortgage role, a debate restarted by *The Turner Review*, which questioned whether more effective regulation of the mortgage market, through either tighter conduct rules or direct product regulation would require the extension of the FSA’s remit to cover second charge mortgages and buy-to-let mortgages.⁷⁸ The government in the recent Treasury White Paper, *Regulating Financial Markets*,⁷⁹ committed to reviewing the case for making us responsible for both.

77 Strictly speaking, we are responsible for regulating loans secured by a first charge on the UK property, where 40% or more of this property is occupied by either the borrower or a close family member.

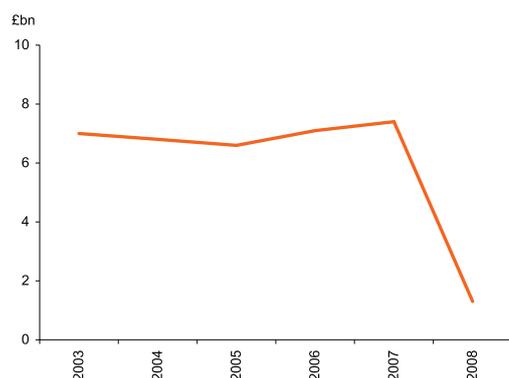
78 Ibid (page 108).

79 *Regulating Financial Markets*. The Treasury. July 2009.

Background – second charge

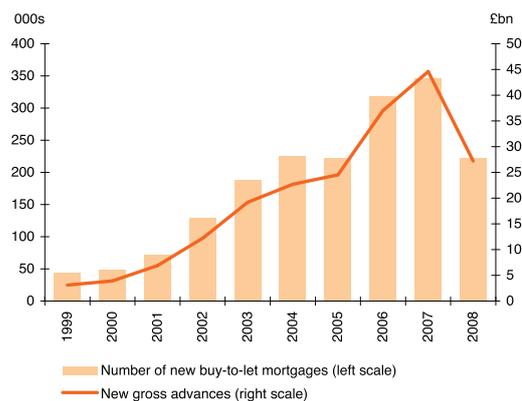
- 9.5 As shown in exhibit 9.1, the second charge market accounted for around £7bn in new advances at its height in 2007. This is obviously small relative to the size of the overall mortgage market at that time. The numbers of lenders and intermediaries involved in the second charge market has been correspondingly small, with many either FSA authorised for mortgage business or part of a wider group authorised by the FSA.

Exhibit 9.1:
**Secured personal lending
(2nd charge mortgages), value of sales**



Source: Mintel estimate based on CML data and trade interviews

Exhibit 9.2:
Number and value of buy-to-let mortgage sales



Source: CML

- 9.6 Second charge lending potentially provides a cost-effective borrowing option as an alternative to either remortgaging or taking out a further advance. This is particularly the case where there might be significant early repayment charges on the first mortgage. It is also a market associated with consumers looking to borrow in circumstances when a first charge lender may be unwilling to lend. Not all second charge consumers will be credit-impaired, but a substantial number will be.

Background – buy-to-let (BTL)

- 9.7 Unlike second charge lending, BTL is a relatively new phenomenon, but also a much larger one. The market has grown rapidly. Exhibit 9.2 shows that gross advances were £3.1bn in 1999 (2.7% of gross mortgage advances) but had grown to £44.6bn (12.3%) by 2007. In the years from 2000 to 2007 the BTL market grew in the region of 20% a year. As with other parts of the mortgage market there has been a subsequent readjustment, with gross advances of £27.2bn at the end of 2008, i.e. a drop of 39% within a single year. At the end of the first half of 2009, the stock of outstanding BTL mortgages amounted to approximately £140bn (as compared to approximately £1.09trn for residential home ownership mortgages [excluding BTL]).
- 9.8 Much of the market growth was fuelled by a new kind of private sector landlord – one with a small property portfolio. A survey for the 2006 Rugg Review of the Private Rental Sector (PRS) concluded that, of the 2.617 million private rental properties in

the UK,⁸⁰ 35% were accounted for by property portfolios of just one property and an additional 28% by property portfolios of between two and five properties. Assuming that the portfolio structure of the PRS in general is similar to the structure of the subset that is funded through mortgages (as opposed to owned outright), we conclude that the BTL sector has a significant portion of borrowers with small portfolios and potentially limited knowledge of the complexities of a BTL mortgage.

- 9.9 The borrowing needs of these landlords, whose motivation has been as much the quick gains from a rapidly appreciating property market as the steady rental income, has been met by both new and existing lenders. In particular, the specialist intermediary lenders (often predominantly wholesale funded) played a large part in meeting demand – in much the same way as these lenders catered for the needs of credit-impaired borrowers.

Issue analysis – second charge

- 9.10 Our interest in a stable and sustainable financial market inevitably means that we have regard to secured lending, even though legislation limits our direct regulatory responsibilities to first charge mortgages. So, for example, our prudential oversight of FSA regulated firms includes assessing their wider secured credit exposures. Similarly, our financial capability initiatives extend to wider borrowing and debt issues.
- 9.11 This paper also highlights the close links between first and second charge mortgage considerations. Our proposals in relation to responsible lending, for example, include proposals to ensure a better assessment of affordability. An inevitable consequence of this is that some lending previously considered acceptable will no longer be permitted. Consumers unable to access the first charge market are likely to look to the second charge market to meet their needs. Not only would this potentially involve higher cost and so be less affordable for the consumer, perversely it would also mean that they would not have the benefit of the regulatory enhancements that our proposals aim to deliver.
- 9.12 A similar issue arises when looking at the enhanced sales standards we are proposing for both advised and non-advised sales (see Chapter 5). A check on affordability and appropriateness in all sales could inadvertently result in firms and consumers circumventing these stricter regulations by taking out less stringently regulated second and subsequent charge loans.
- 9.13 Consumers taking out second and subsequent charge loans will, of course, still benefit from the protections afforded under consumer credit legislation. Recent enhancements to that legislation allow the Office of Fair Trading (OFT) to apply new scrutiny to the secured lending market. However, the fact remains that the distinction in regulatory responsibility, and differences in the underlying legal framework, pose a strong challenge to our (FSA and OFT) shared interest in securing consistent, high quality outcomes. The step-change in regulation that we are looking to bring to the first charge market will only widen the existing gap.

80 This figure has been verified through cross references with data from Mintel, Datamonitor, and CML. Taking into consideration a slight sampling error due to exclusion of a number of SLAs the data is inline and thus assumed reliable.

- 9.14 As we discuss in Chapter 10, the European Commission has a strong interest in the operation of mortgage markets and whether intervention is necessary to boost consumer protection or facilitate greater integration. European policymakers do not make a distinction between first and second charge lending. Their focus is on a simple distinction between loans that are secured and those that are not. While other markets share the concept of having multiple charges on a property, and prioritising these, this has little impact on the regulatory approach adopted. The UK appears alone in distinguishing between secured loans in the way it does.
- 9.15 A final relevant consideration for us stems from our interest in financial capability and a market characterised by confident, well informed consumers. The present differences in the standards applying to first and second charge mortgages are not easy to explain and the reason for any distinction is unlikely to be obvious for consumers.

Issue analysis – BTL

- 9.16 As with second and subsequent charge lending, there are a number of reasons for our market analysis extending to the question of BTL regulation. There appears broad consensus among commentators that BTL has played a full part in fuelling property price appreciation. As well as being a general contributor, BTL funding has particularly helped to inflate prices of certain property types and locations, such as city centre apartments. The overall impact on house prices inevitably has implications for our interest in the sustainability of the mortgage market. Regulation of BTL should improve the quality of borrowing and lending decisions, going some way to alleviating this upward pressure.
- 9.17 Most BTL lenders are already authorised by us for their first charge mortgage business. One consequence of this is that we currently have regard to the prudential risks of their activities. This will be reflected in the requirements for regulatory capital, for example. Our interest is clear where the unregulated BTL activities have the potential to significantly impact on the wider firm. However, as the earlier discussion regarding high-risk lending highlighted (see Chapter 3), there are potential issues with the corresponding prudential requirements applying to non-bank lenders. Many of the non-banks also expanded into BTL, and any decision to extend the scope of regulation will be a further prompt to reassess the prudential regime applying to non-bank lenders, and vice versa.
- 9.18 While the increase in property investment through BTL mortgages has had a beneficial impact on the expansion of the private rental sector, the market has proved to be unsustainable. As we noted earlier (exhibit 9.2), there was a significant year-on-year expansion and then an even more rapid contraction in lender numbers, product availability and sales income for firms. So the partial regulation through our prudential oversight has not been enough to ensure stability and sustainability.
- 9.19 The losses reported by some lenders from their BTL activities also sheds light on the sustainability of the market. These losses suggest the failure to properly understand the risks in the market, for example, by having insufficient regard to the ongoing viability of contracts. Just as the residential mortgage market saw firms adopting a less

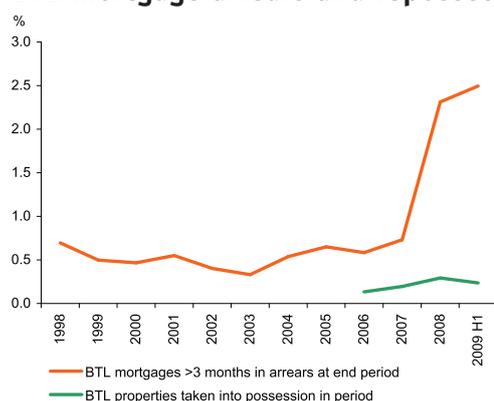
rigorous approach to their lending decisions, so BTL deals were increasingly available at lower margins and with reduced rental cover. Firms also looked to widen their consumer base, with one result being that at the market peak there were more than 1,300 credit-impaired BTL products.⁸¹

9.20 Of course, further very public examples of firms failing to adequately manage BTL risks are the reported incidents of mortgage fraud. While fraud levels overall remain low relative to the total volume of mortgage transactions, several investigations have now highlighted the scope for collusion between developers, estate agents, valuers and intermediaries.

9.21 As discussed earlier, consumers were attracted to the BTL market because of the apparently unending appreciation in property values rather than the steady return from rental income. The recent increases in the level of BTL arrears, at a time when historically low interest rates should be increasing the affordability of interest-only loans, is a strong indicator that not all sales adequately considered the consumer's interests (see exhibit 9.3).

Exhibit 9.3:

BTL mortgage arrears and repossessions



Source: CML

9.22 As BTL is unregulated, there are no specific standards lenders should follow. The same is true for intermediaries, which is of concern because, much more than in the residential market, many BTL lenders used intermediaries as their principal distribution channel. The lack of sales standards holds true both for the loan transaction viewed in its own terms, and the potential appropriateness of BTL as an investment. At a time when more traditional investments have been delivering relatively low returns, rising house prices have made BTL an attractive alternative to products such as pensions. However, the consumer making this decision may well have a limited understanding of the implications of treating property as an investment. There will also be no regulatory framework for explaining this, or for addressing the information asymmetry likely to exist between the firm and consumer.

9.23 The UK is not alone in having a BTL market. The presence and strength of the market in other countries varies with cultural biases towards renting or owning property, and with the availability of incentives (usually tax benefits) for one or the other. Where the market has developed, the firms involved tend to be those also in the residential mortgage

81 Moneyfacts. June 2009

market. The regulation that exists follows the same pattern, with several countries not distinguishing between loans secured on the borrower's own residence and those secured on another property.

Conclusion

- 9.24 We are concerned that our efforts to ensure improvements in the quality of first charge mortgage business is likely to force less sustainable lending into markets where different regulatory standards apply. The Consumer Credit Act, even in its amended form and with active OFT oversight, will not be able to tackle in the same way any unsustainable lending and borrowing that migrates its way. The unregulated buy-to-let market offers yet further gaming opportunities.
- 9.25 We firmly believe that effective delivery of a stable and sustainable mortgage market calls for similar standards to apply across all secured lending to consumers. This removes the otherwise significant possibility of our changes to the regulation of residential mortgages being 'gamed'. Extending our regulation to second-charge loans will also simplify the regulatory framework for firms and consumers; it will remove distinctions and differences in regulatory approach that don't relate to risk; and unified regulation would allow for better oversight, both prudentially and in the assessment of loan affordability.
- 9.26 Similarly, we support bringing buy-to-let within regulation as it would address an identified risk to market sustainability. As with the second charge change, it strengthens oversight arrangements. It also offers the potential for protecting consumers making investment decisions on property.
- 9.27 The practical implications of bringing BTL within scope will need careful consideration. While borrowers taking out first and second and subsequent charge lending are owner-occupiers, borrowers taking out BTL are landlords. Landlords and their tenants benefit from the existing legislative framework that applies (and will continue to apply) across the wider private rented sector. The government is currently consulting on proposed changes to the framework of regulation of the PRS and also consulting on proposed changes to address concerns about a gap in legal protections for the tenants of borrower landlords facing repossession. We would need to have regard to this wider legislative background when developing our regime.
- 9.28 Moreover, our particular concern relates to private investors who, as 'amateur landlords' or small business borrowers, are poorly placed to protect their own interests.⁸² If a case for a scope extension is made in terms of protecting smaller investors/businesses, a key consideration will be defining the characteristics of such investors to ensure that regulation is not applied more widely than necessary.
- 9.29 We understand that the government will be consulting shortly on both scope extensions.

82 We estimate that 35% of all BTL landlords hold property portfolios of just one property, and an additional 28% with portfolios of between two and five properties

10 Other matters for discussion

Protecting consumers when mortgage books are sold on

- 10.1 The government will also be consulting shortly on the best way to protect consumers when lenders sell on mortgage books.
- 10.2 There has been growing concern at the number of regulated mortgage books being sold by mortgage firms seeking to limit their losses or raise funds. These sales are typically at a discount and have attracted hedge funds and private equity firms.
- 10.3 Firms acquiring mortgage books will not necessarily be engaging in a regulated activity. And of course firms not engaging in a regulated activity are not bound by our requirements, including the requirement to treat consumers fairly. There is a concern that firms acquiring mortgage books may seek to maximise margins by raising interest rates and charges to potentially unaffordable levels. The lack of regulation may be a factor in the decision to purchase these mortgage books.
- 10.4 The government therefore proposes to consult on extending the scope of FSA regulation to ensure that the acquisition of mortgage books is a regulated activity to ensure borrowers continue to benefit from the protection provided by our regime.

Data requirements from lenders

- 10.5 Changes to our regulatory approach will inevitably result in a need to review the current data collected in respect of mortgages (PSD, MLAR and to a lesser extent RMAR⁸³). Until our proposals are clearer, we will not be able to fully identify how we expect existing data requirements to change. Nevertheless, there are three key gaps in the data we receive that may require changes regardless of final proposals.

83 Product Sales Data (PSD), Mortgage Lending and Administration Return (MLAR) and Retail Mediation Activities Return (RMAR)

Being able to track arrears/repossessions cases back to the original product transaction

- 10.6 Although we collect data on both individual mortgage transactions (PSD) and arrears/repossessions performance (MLAR), we are not currently able to link individual arrears/repossession back to the original transaction. This limits the extent that we can analyse the drivers of arrears/repossessions at an individual transaction level.
- 10.7 Lenders have been supplying PSD reports on a quarterly basis since April 2005 and each transaction has a unique transaction reference number. So it is possible for lenders to supply us with data that links the arrears/repossession back to the original transaction by using the unique transaction reference number.
- 10.8 The Council of Mortgage Lenders (CML) has recently helped us obtain a one-off transaction arrears data report from a cross-section of banks, building societies and non-bank lenders – covering the period from April 2005 to August 2009. Despite only providing lenders with a six-week window, the vast majority of lenders were able to report the data to a good standard.
- 10.9 We propose to require this information on a permanent basis as part of firms' Regulatory Reporting requirements (for example, via PSD reporting). However, system changes will take time. Such is the importance of transactional arrears data we would therefore like lenders to submit this data (as set out in exhibit 10.2) on an interim basis in advance of any system changes.

Exhibit 10.2:**FSA PSD – Arrears and repossessions data request**

This request only applies to mortgage accounts that are currently in arrears or where a possession order or possession has taken place since the original PSD transaction was reported.	
Data field	Description
PSD transaction reference number	The same transaction reference number that was used to report the initial PSD transaction
Current balance outstanding	The balance outstanding on the account at [insert date]. This should include any arrears, fees and charges that have accrued and have not yet been paid off.
Amount of arrears	The actual amount of arrears outstanding on the account at [insert date] Definition of arrears – ‘Arrears will arise through the borrower failing to service any element of his contractual debt obligation to the firm, including capital, interest, or fees, fines, administrative charges, default interest or insurance premiums’.
Date of possession order	Where applicable the date the Court officially granted the lender a Possession Order.
Date of possession	Where applicable the date the lender took physical possession of the property.
Current interest rate	The interest rate applicable to the account as at [insert date]. Where more than one interest rate applies to the account, please report the interest rate applicable to the largest proportion of the mortgage account.
To be included	
<ul style="list-style-type: none"> • Regulated first charge mortgages only • Loans that have been securitised but where the loan is still serviced by the lender or nominated third party should be reported. • Where a further loan has been granted since the original PSD transaction was reported, please conflate any further advance with the original loan where possible and reflect in both the current balance outstanding and the amount of arrears 	
To be excluded	
<ul style="list-style-type: none"> • Loans where the original PSD transaction was reported by the originating lender but was sold to another lender on or after completion of the loan. • Loans acquired but not originated unless the acquiring lender is able to report the same transaction reference number used by the originating lender to report the initial transaction. 	
Data format – CSV (Comma Separated Values)	

Q29: Do you agree that the FSA should collect data to enable us to track arrears and repossessions cases back to the original product transaction on a permanent basis?
What would be the costs imposed on the market?

Definitional issues

- 10.10 There have long been concerns about the lack of standard industry definitions in respect of self-certification, fast-tracked, subprime and related types of lending. We are proposing that all mortgages will require income verification and so a standard definition for self-certification may no longer be an issue. But in respect of subprime, there has never been any industry consensus as to what a subprime mortgage is and what it includes.
- 10.11 We describe subprime as impaired credit lending only, which is defined in MLAR as lending to a borrower who has a record of:
- arrears on a mortgage or secured loan within the last two years, where the cumulative amount overdue at any point reached three or more monthly payments; or
 - arrears on an unsecured loan within the last two years, where the cumulative amount overdue at any point reached three or more monthly payments; or
 - one or more county court judgements (CCJs), with a total value greater than £500, within the last three years; or
 - Individual Voluntary Arrangement (IVA) within the last three years; or
 - bankruptcy within the last three years.
- 10.12 The CML refer to adverse credit lending and others refer to non-conforming lending. Terms such as 'near-prime' or 'extra-light subprime' are also in use.
- 10.13 We therefore consider standardised industry definitions around subprime (and possibly in other areas) would be useful to easily distinguish different types of lending risks and to facilitate easy analysis of the data.

Q30: Do you agree the FSA should standardise some existing industry definitions such as subprime? And if yes, are there any existing definition issues other than subprime?

Fees and charges

- 10.14 We have already set out our concerns around lenders charges and our intention to do further supervisory work into the levels of lender product charges and lender charging models (Chapter 8). We also consider that we need to collect better data from lenders on the following fees and charges on an ongoing basis to monitor compliance with our MCOB rules:
- arrangement/application fees/set-up fees;
 - procuration fees;
 - early repayment charges;
 - intermediary fees; and
 - arrears charges.
- 10.15 We are still considering the most cost-effective way to collect information on charges set by lenders. It may not be feasible to require this data for every individual borrower at a transactional level. However, we would like regular information on lenders' charges and procuration fees and would want to be confident that these reflected actual charging practices.
- 10.16 In terms of intermediary fees, we currently ask intermediaries to report fee income from regulated mortgages in their six monthly RMAR. It is however difficult to determine with any degree of accuracy what this means on a case-by-case basis. So we considering asking lenders to supply this data based on the fee income intermediaries quote in the KFI.
- 10.17 We are seeking comment on the feasibility of collecting all or some of this data directly from lenders on an ongoing basis as part of regulatory reporting and the potential costs involved.

Q31: What are the potential compliance costs if the FSA collected better data on fees and charges directly from lenders on an ongoing basis as part of regulatory reporting?

Financial crime and mortgage fraud

- 10.18 Our financial crime objective is to reduce the extent to which it is possible for a business to be used for a purpose connected with financial crime. This includes keeping criminals and their associates outside the regulated community. We are actively addressing financial crime issues in the mortgage market. For example, we continue to pursue our credible deterrence approach and have in the past year banned and fined over 50 intermediaries for fraud or malpractice. We are also working on a number of mortgage fraud investigations with the City of London Police, the lead force on fraud in the UK, and many other police forces around the country.

- 10.19 We also continue to encourage the reporting of mortgage fraud as part of our ‘Information from Lenders’ scheme. We strive to ensure that lenders have robust systems and controls in place that can act to prevent fraud and are working on addressing any gaps that have become apparent. We are working with firms, industry trade bodies and organisations to facilitate cooperation and the exchange of information and best practice to tackle mortgage fraud more effectively. In particular, we recently participated in a mortgage fraud roundtable between law enforcement, regulators and organisations, which addressed gaps in information exchanges between those bodies.
- 10.20 Several proposals outlined in this DP, combined with more sophisticated fraud detection techniques, are expected to help address mortgage fraud. They are depicted in exhibit 10.3. The requirement for income verification for all mortgage applications is expected to curb income inflation, a form of mortgage fraud in which the consumer is complicit. Our proposal will contribute to ensuring that applicants apply for mortgages that they can demonstrably afford.
- 10.21 We will also make our rules on affordability assessments more prescriptive; and will also support EU proposals for limits on the risk transfer through mortgage backed securities. We are proposing to extend the Approved Persons regime which will enable us to better detect and take action against professionals that are known to have been non-compliant. This can only be a partial solution, as the majority of the problem professionals are not regulated by the FSA, however the initiatives described above should help address this.
- 10.22 Finally, as we have already discussed, we believe that our regulatory scope should be extended to buy-to-let (BTL). Several investigations have highlighted the scope for collusion between developers, estate agents, valuers and intermediaries to commit fraud against lenders.

Exhibit 10.3:

Proposals with positive impact on fraud

Proposal	Market actors impacted
Make income verification a requirement for all mortgages	Lender, intermediary
Clarify ultimate responsibility to assess affordability lies with lender, who will be held accountable	Lender, intermediary
More prescriptive rules on affordability	Lender, intermediary
Re-establish incentives for lenders to care about plausibility of income, through limits on risk transfer	Lender, investor
Increase sales standards for ‘non-advised’ sales	Intermediary, lender
Extend Approved Persons regime to individual intermediaries	Intermediary
A professional standards board for intermediaries	Intermediary
Extend regulatory scope of the FSA to buy-to-let	Lender, intermediary

- 10.23 All these measures should reduce the opportunities for lenders, intermediaries and borrowers to engage in fraudulent activities.

Q32: Are there any additional measures that you feel the FSA could take to reduce the risk of financial crime?

Equity release

- 10.24 Equity release describes a range of products only available for older people, typically over the age of 55, which facilitate the release of equity tied up in their property. Products have no fixed term, allow the consumer to remain in their property for life and only come to an end when the consumer dies, sells the property or moves out of the property into long term care.
- 10.25 The equity release market has been the subject of repeated predictions of strong growth. Yet, the gross value of equity release at the peak of the mortgage market in 2007 was £1.3bn, compared to gross mortgages advanced in the entire market that year, which reached £364bn.⁸⁴ In recent times, equity release has appeared a little more resilient than the standard market, with around £1.1bn released in 2008, but at these volumes, it clearly remains a niche. Sales have never exceeded 30,000 transactions per year.⁸⁵
- 10.26 For the purpose of our review we looked at the equity release market from first principles, aiming to capture all the potential causes of risk to consumers, lenders or the sustainability of the market overall. Despite the different product purpose, we conclude that equity release is by and large funded, designed, distributed and administered in ways broadly comparable with the standard mortgage market.⁸⁶ We found that there are several additional issues specific to equity release. These include the rapid consumption of housing equity, the risk of undervaluation, uncertain security of tenure, negative equity and the safety of any beneficial interest.
- 10.27 An issue that has been brought to our attention as yet another concern specific to this segment is the potentially greater vulnerability of equity release consumers compared to the standard market. However, the Financial Capability Baseline Survey tells us that those under forty are typically much less financially capable than those over forty.⁸⁷ This is true even allowing for their generally lower levels of income and experience in dealing with financial institutions. Conversely, as a group, the over sixties are generally more capable at budgeting, planning ahead and staying informed about financial matters.
- 10.28 We also know from the Mortgage Effectiveness Review that lifetime mortgage consumers typically spend much time researching their choices and reviewing any purchasing decision with family, friends and advisers (both legal and product). Both findings suggest that this should not be an issue that warrants further regulatory intervention.

84 CML (2008) *Please release me. CML research report*

85 Mintel (2009), *Equity Release, Finance Intelligence*, pp. 9, 41, 44

86 It is important to note though that insurers play a much larger role in this market, as do professional investors (especially for home reversions).

87 FSA (2007), *Finance in and at Retirement*

- 10.29 Due to the small size of the market, complaints and evidence of consumer detriment will be slow to emerge. A further complication is that concerns may only come to light some years down the line when the borrower (or their beneficiaries) assesses the impact on the estate. Finally, we have no evidence that would suggest that the equity release market is unsustainable. Recent significant market exits of providers can be traced to wider funding difficulties rather than inherent problems in their equity release business models.
- 10.30 Our main source of evidence is the thematic work undertaken first on lifetime mortgages and more recently on equity release. This has focused on a firm's approach to the sale, an initial priority because of our assessment of the segment being high-risk. We found the issues comparable with those in the standard mortgage market. While we have seen good practice, there is also considerable evidence of firms failing to properly assess needs and circumstances, or being able to show suitability. At least initially, the thematic work also highlighted inappropriate strategies such as encouraging consumers to borrow to invest or using equity release to mitigate potential inheritance tax obligations.
- 10.31 Since making our concerns known, follow-up work has found less evidence of these strategies. The most recent thematic work has also found that firms only occasionally undertaking equity release business are carrying out satisfactory sales.
- 10.32 Based on the available evidence, we therefore conclude that our existing conduct of business regulation appears to address the likely causes of consumer detriment, and we have no reason for advancing specific additional proposals on equity release. We also believe that the market appears sustainable for firms and consumers, although we acknowledge that the number of interested players has remained limited.
- 10.33 Furthermore, the proposals developed in this paper for the standard mortgage market will also affect the equity release market. We intend to supervise our conduct of business rules more stringently going forward, and this will include firms operating in the equity release segment. Our proposals on sales standards and basic appropriateness checks, too, will have beneficial effects on this segment. Finally, our move towards more restrictive product regulation signals our more general intention to restrict access to high-risk products.

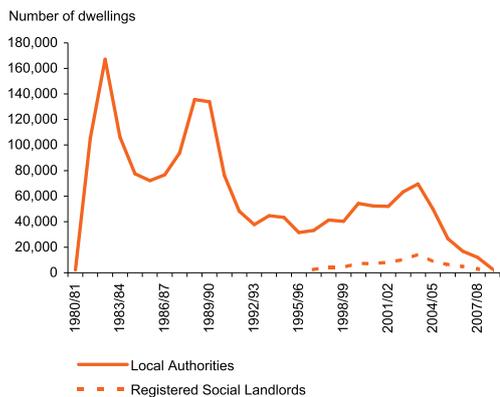
Right-to-buy

- 10.34 Right-to-buy (RTB) schemes enable local authority tenants (who meet a minimum tenancy length) to buy their current home at a discount, which is usually worth several tens of thousands of pounds. The most common way of financing these purchases has been through mortgages, as council house tenants rarely have the financial means to acquire the property outright.
- 10.35 Since its introduction in 1980, 2.2m public sector tenants in Britain have gained access to home ownership through the RTB scheme.⁸⁸ At the peak of the market in the 1980s and the early 1990s, more than 100,000 RTB transactions were carried out per year. By 2008/9 that figure dropped to below 1,000; as depicted in exhibit 10.4.

88 DataMonitor (2005), *UK Right to Buy Mortgages*

Exhibit 10.4:

Social housing sales: Local Authority and Registered Social Landlord stock sold through the right-to-buy scheme, England



Source: DCLG

- 10.36 The decrease in market transactions can be traced to various factors. The Housing Act 2004, increased the minimum time period required for a tenant to be eligible to buy his property from two to five years. Also, many local authorities reduced the discounts available to consumers, which reduced demand even further. Whatever the causes, the RTB segment is very small and accounts for less than one percent of the overall mortgage market.
- 10.37 The Department for Communities and Local Government (DCLG) is responsible for the RTB scheme, and provides eligible tenants with information about exercising their right to buy. In 2003, it commissioned some research into the RTB scheme and the companies that target eligible tenants, encouraging them to exercise their right to buy in return for a cash lump sum. These companies offer a wide range of services to council tenants to help them purchase their home, which encompass filling out the relevant forms, negotiating with the council, organising solicitors and arranging mortgages.
- 10.38 The research identified several areas of concern about these firms, including cold-calling and unsolicited doorstep selling by firms; pressurised selling techniques and the misrepresentation of the local authority to potential clients; and excessive charges and fees.⁸⁹
- 10.39 The subsequent Housing Act 2004 appears to have addressed much of the consumer detriment in RTB sales. The Act, which came into force in January 2005, required firms to provide specific information to eligible tenants about exercising their right to buy, including when the right to buy can/can't be exercised; the costs incurred in buying a property; and the risk of repossession.
- 10.40 However, some reports continued to highlight problems in the market. A more recent report by the Citizens Advice Bureau indicated that 15 percent of their mortgage case load relates to RTB cases, although this is occurring in a market with an ever-decreasing

89 ODPM (2003), *Exploitation of the Right to Buy Scheme*

number of transactions.⁹⁰ The common theme amongst most of those cases appears to be the exploitation of information asymmetries between firms on the one hand and the tenants in council or housing association homes on the other, who tend to be particularly vulnerable because of their age, state of mental health, physical disability, and literacy or language difficulties. Also, a considerable proportion of households eligible for the RTB scheme do not have access to the mainstream mortgage market, due to their low incomes and/or bad credit histories.

- 10.41 In many cases, the consumer detriment may be the result of the unsuitable and/or unaffordable sale of mortgages to individuals who often would have been better off without one. This does potentially raise issues for us. For although RTB schemes are not explicitly regulated by us, the sales process certainly is, to the extent that it relates to an advice, arranging and lending activity (and not solely to the canvassing activity of some firms, which is outside our remit). A cursory look at the arrears rates of RTB mortgages and standard mortgages, derived from the DCLG Survey of English Housing, seems to confirm our hypotheses regarding non-affordability. Borrowers who bought from a council or housing association are two to three times more likely to fall into arrears than someone with a standard mortgage.
- 10.42 We therefore took action against firms that did not comply with our mortgage rules and in 2005/06, five of the ten most active firms in the RTB market had enforcement action taken against them for a variety of reasons, not necessarily specifically related to RTB issues.
- 10.43 Given the similarities in failings on suitability and affordability checks, our view is that the proposals to strengthen affordability assessments (discussed in Chapter 4) will help address the issues in the RTB market. Our proposals regarding sales standards and basic appropriateness checks will have a beneficial impact on this market segment, as will our move towards more restrictive product regulation, the extension of the Approved Persons regime, and various other initiatives. We therefore conclude that no additional measures specific to the RTB segment are required. We also believe that the extent of any detriment that may still arise will be limited, due to the expected small size of this market segment in the future.

Q33: Do you agree that the cumulative effect of the policy levers as outlined within our DP will have a positive effect on;

- (i) the equity release market; and/or
- (ii) the right to buy market

90 CAB (2007), Clarifying the Right to Buy Rules – Citizen’s Advice response to the Department for Communities and Local Government Consultation.

EU policy dependencies

- 10.44 The European Commission continues to show great interest in mortgage market policy interventions in the name of delivering greater consumer protection. This is in addition to the various initiatives it has already started on prudential and funding matters.
- 10.45 In the Communication to the Spring European Council in March 2009 the European Commission made a commitment to come forward with measures on responsible lending and borrowing, including a reliable framework on credit intermediation.
- 10.46 Subsequently the European Commission published a consultation on responsible lending and borrowing in the EU which sought views on a wide range of issues including: how to change the European Standardised Information Sheet (ESIS) to make it more effective and whether to make it binding; sales standards such as suitability and creditworthiness; the role of product regulation and advice standards, and the need for a framework on credit intermediation.
- 10.47 The scale and complexity of the UK mortgage market as a part of the EU markets means that any Commission intervention would impact disproportionately on the UK. For example, between them the UK and Germany have 45% of the €27trn of total outstanding residential loans in the EU-27.
- 10.48 Recent events have demonstrated the interconnectedness of financial markets across the globe. The recent challenges have shown the need for a strong international framework and close cooperation between national authorities on preventing, managing and resolving crises in financial markets. Given the breadth and depth of the crisis, any response needs to adopt a wide view of potential policy levers available, including corporate governance, remuneration policies and prudential supervision. These could all be important tools. The linkages between these and other policy levers are complex and not yet fully understood.
- 10.49 As the Commission is already taking action on the wider front through reforming the Capital Requirements Directive or legislation on the regulation of Credit Rating Agencies, they should consider the effectiveness of these measures before it undertakes further action.
- 10.50 We are working to understand the specific problems in credit markets that the financial crisis has brought to light. We believe that our comprehensive review in response to market issues removes the need for Commission intervention in the UK. We have engaged with the Commission and shared our analysis and conclusions. We think that it should be encouraging other Member States to undertake programmes of work similar to this review on their national markets and to compile the findings. This would help provide a strong evidence base to identify common themes, highlight best practice, and ensure that any response at the EU level is effective and proportionate.

Summary of DP questions

Chapter	Questions
1	No questions.
2	No questions.
3	<p>Q1: Do you agree that the prudential reforms will ensure that banks and building societies are adequately capitalised for the risks inherent in mortgage lending and should support a more stable mortgage market through the economic cycle?</p> <p>Q2: Do you agree with our analysis of the implications of applying higher capital requirements to high-risk loans (on top of the prudential reforms) and that to do so would not be likely to protect borrowers from the risks of taking on such loans?</p> <p>Q3: Do you agree that more direct intervention through business model analysis; applying asset limits; or increased prudential requirements is required to deal with the consumer and systemic risks posed by non-deposit taking lenders?</p> <p>Q4: Are there any other considerations that are relevant to the issue of how prudential requirements influence mortgage market outcomes?</p> <p>Q5: Do you agree with our analysis that, on the grounds of consumer protection, there is no case for prohibiting the sale of loans above certain LTV, LTI or DTI thresholds?</p>
4	<p>Q6: Do you consider that the FSA should prohibit the sale of mortgages to borrowers with multiple high-risk characteristics? If yes, what particular combinations of risk factors should the FSA consider prohibiting and why?</p>

- Q7: Do you consider that requiring verification of income by the lender for all mortgage applications is a viable option, and one which is sufficient to ensure responsible and sustainable levels of mortgage lending?
- Q8: Do you agree with our proposal to require lenders to take ultimate responsibility for affordability?
- Q9: Do you agree with our proposal to require lenders to assess affordability based on;
- (i) the borrowers free disposable income;
 - (ii) a consumers borrowing capacity;
 - (iii) the plausibility of the information obtained; and
 - (iv) a capital repayment basis?
- Q10: Is the increased focus on affordability the right way to ensure sustainability of lending and consumer protection?
- Q11: Are there any additional policy levers we should use to curtail income inflation and related mortgage fraud?
- Q12: Do you think that the FSA should limit the amount of equity a consumer can withdraw from their home?
- Q13: Do you agree that we need to strengthen the selling standards for non-advised (information-only) sales to ensure consumers are only entering into contracts which are both affordable and appropriate?
- Q14: What measures should the FSA take to ensure sales standards in advised sales meet the needs of the market and appropriately protect consumers?
- Q15: To what extent should intermediaries retain responsibility for assessing a consumer's ability to repay? How could this work in practice?
- Q16: Do you agree that suitability letters should be introduced as a compulsory standard?
- Q17: What are the implications of applying the Approved Person's regime to all individual mortgage intermediaries?
- Q18: Do you agree with our conclusion not to read across the adviser charging element of the RDR proposals into the mortgage market?

- Q19: Are there any other considerations that are relevant to the assessment of the issues and risks posed by the current remuneration model within the mortgage market, which are not identified within the DP?
- Q20: To what extent should the proposals for a PSB as outlined in the RDR be extended to the mortgage market?
- Q21: Do you agree that simplified scope of service labelling, limited to 'independent' or 'restricted advice' and also describing a non-advised service as 'information-only', will result in better consumer understanding of the services on offer?
- 6 Q22: Do you agree with the proposals to;
- (i) remove the requirement for the IDD and replace with disclosure of key messages;
 - (ii) retain use of the KFI; and
 - (iii) require elements of disclosure to be carried out on an oral basis?
- Q23: Do you agree that the limitations on the rationality of consumer behaviour in the mortgage market support the case for greater regulatory intrusion?
- Q24: Do you agree that the FSA has a role in preventing the extension of credit to individuals who are unable to afford such high levels of debt?
- Q25: Do you have any comments on the financial capability initiatives designed to support the overall mortgage market reform?
- 7 Q26: Do you have any comments on our proposals to strengthen our approach to firms' arrears management practices?
- 8 Q27: Do you consider that the mortgage market fees and charges reflect the underlying costs or are consumers paying excessive charges?
- Q28: What would be the impact of consumers not being allowed to roll up intermediary fees and product charges into the mortgage loan?
- 9 No questions.

- Q29: Do you agree that the FSA should collect data to enable us to track arrears and repossessions cases back to the original product transaction on a permanent basis? What would be the costs imposed on the market?
- Q30: Do you agree the FSA should standardise some existing industry definitions such as subprime? And if yes, are there any existing definition issues other than sub-prime?
- Q31: What are the potential compliance costs if the FSA collected better data on fees and charges directly from lenders on an ongoing basis as part of regulatory reporting?
- Q32: Are there any additional measures that you feel the FSA could take to reduce the risk of financial crime?
- Q33: Do you agree that the cumulative effect of the policy levers as outlined within our DP will have a positive effect on;
- (i) the equity release market; and/or
 - (ii) the right to buy market

High-level cost benefit analysis

Introduction

1. We have analysed the nature of competition and the types of market failure in the residential mortgage market. We have also carried out a high-level analysis of the potential costs and benefits that are likely to arise as a result of the package of proposals set out in this paper. The analysis will inform the policy development process going forward.
2. In our analysis we have taken into account the fundamental prudential reform already under way and developments under *The Turner Review* (described in detail in Chapter 3). But the impacts of these prudential initiatives are not within the scope of this CBA.
3. We will conduct a full cost benefit analysis (CBA), that is an estimate of the costs and an analysis of the benefits, once detailed rules are proposed at the Consultation Paper stage.
4. This chapter is structured as follows:
 - Section 1: Analysis of the mortgage market: the nature of competition and market failures;
 - Section 2: Overall CBA of the package of proposals;
 - Section 3: CBA of proposals under ‘product regulation’ and ‘sales regulation’;
 - Section 4: CBA of proposals under ‘distribution and advice’;
 - Section 5: CBA of proposals under ‘unfair charges and practices’; and
 - Section 6: Transition and timing issues.
5. In our analysis we have used the following sources of information: Mortgage Lenders and Administrators Returns (MLAR), Product Sales Data (PSD), supervisory intelligence, findings from a number of surveys commissioned by the FSA, and relevant academic research.

Section 1: Analysis of the mortgage market: the nature of competition and market failures

6. We have carried out a high-level competition and market failure analysis of the mortgage market. Our main findings are summarised in Box 1 and the details follow below.

Box 1: Summary of findings

- We have found no evidence to suggest that any material structural changes in the market have adversely damaged competition (there are many lenders and intermediaries and moderate market concentration). However, the mortgage market is currently undergoing a period of transformation. Some of the changes observed over the past two years may be temporary, reflecting the current state of the economy, but others may reflect structural shifts that over the long-term could give rise to more serious competition concerns.
- Competition in the prime mortgage market seems to focus on headline interest rates while profits are typically derived from those loans persisting beyond the introductory rate and from add-on fees and charges.
- Some specialist lenders entered the market by targeting customers with adverse credit histories and making lending decisions based to a great extent on the underlying collateral.
- Some lenders and intermediaries have benefited from consumers' behavioural biases and risk-taking preferences by selling foreseeably unaffordable mortgages and increasing mortgage related charges.

7. The mortgage market is currently undergoing a period of transformation. Some of the changes observed over the past two years may be temporary, reflecting the current state of the economy. Others may be structural shifts that over the long-term could give rise to competition concerns. So our analysis below, and findings, may change in the long term.
8. The prime mortgage market features a high number of lenders with a moderate market concentration in the market.¹ High-street banks and building societies active in this market have traditionally funded mortgages from retail deposits and used mainly the direct distribution channel to offer mortgages to customers. There are some barriers to entry in the prime mortgage market, including the need for an established customer base and brand recognition.² Some regulatory requirements are in the nature of sunk costs and therefore contribute to barriers to entry.

1 The commonly used market concentration Herfindahl-Hirschman Index (HHI) for the residential mortgage market is in the region of 0.15 based on the number of transactions using latest FSA's Product Sales Data . According to the Merger Guidelines by the OFT and DG Competition: if HHI is generally above 0.18, a market may be regarded as highly concentrated and may give cause for competition concerns. The recent Lloyds-HBOS merger has led to an increase in market concentration and may give cause for competition concerns in the future, but with the data available it does not seem to be the case at the moment. Also see the OFT report to the Secretary of State on Lloyds/HBOS merger: www.of.gov.uk/advice_and_resources/resource_base/Mergers_home/decisions/2008/LloydsTSB.

2 Most consumers (51 percent) chose their mortgage provider directly with a bank or building society, 28 percent through a financial advisor. It is interesting to note that the share of direct lending (banks or building societies) marginally increased 2007-2008 reversing the previous trend toward financial advisers and mortgage brokers. Source: Mintel (March 2009) 'Mortgages - UK - Channels to Market'

9. At the same time, in the years before the financial turmoil, intense competition among lenders active in the credit-impaired market delivered an undesirable outcome as new entrants offered riskier products in order to gain a foothold in the market, and this prompted incumbents to do the same. Some lenders competed by relaxing their eligibility criteria to sell to those customers with more adverse credit histories and making lending decisions based to a great extent on the underlying collateral. These large volumes of high-risk lending contributed to the increase in house prices in a market where housing supply is perceived to be constrained. Moreover, the recent exit of some of the new entrants has left their customers trapped in contracts with limited ability to switch.
10. Barriers to entry and exit in the credit-impaired market appear to be relatively low, especially for non-deposit taking ('non-bank') lenders. These lenders use wholesale funding and the existing well-developed intermediary distribution channel. Also as non-banks do not have depositors in need of protection, they are subject to much lower capital requirements than deposit-taker lenders (non-banks are subject to MIPRU rather than BIPRU – see 3.43). This confers the competitive advantage of a lower cost base.
11. Some regulatory requirements for mortgage intermediaries may constitute barriers to entry in the intermediated mortgage market. However, the high number of brokers indicates that these may not be so significant as to give rise to regulatory or competition concerns.
12. The main objective of lenders is to maximise the profit of the firm, and when property markets were booming they were doing so by increasing the amounts they lent to creditworthy individuals and by lending to individuals who had previously been excluded from the mortgage market. In theory lenders have an incentive to insist that borrowers demonstrate their ability to repay the loans (e.g. income verification, affordability check, and LTI ratio) and that borrowers have adequate equity in the transaction, so that there will not be losses for the firm if borrowers default (e.g. LTV ratio). However, the ability to pass on lending risks to third parties (e.g. securitisation) and expectations of growing collateral values meant that this incentive was diluted.
13. Consumers differ in their reasons for entering the mortgage market. For example, the desire to own a house rather than renting, changes in household composition, the pursuit of short- and long-term investment opportunities, and satisfying consumption needs through equity withdrawals. Consumers also differ in their risk appetite, some being very willing to take risks, whilst others are very conservative. Consumers' choice of distribution channel is typically explained by their individual characteristics (time available to search, location, financial capabilities, credit history, etc.). This self-selection mechanism typically directs consumers into different mortgage distribution channels where they are served either by lenders directly or by intermediaries, although some consumers may switch between channels, implying limited intra-channel competition.

14. Consumer detriment in the mortgage market arises mainly from a combination of: the tendency of some borrowers to over-extend themselves³, the lack of incentives for lenders to conduct proper affordability checks, especially during periods of rising property prices, and the incentives of intermediaries to complete the transaction.
15. Borrowers have some incentives to over-extend themselves (often even after being aware of risks involved in the transaction) because they expect to benefit from any property price increases. They may also over-extend themselves because they discount the future payment on the mortgages at a much lower rate than the value they attach to having a house now (i.e. cognitive bias). Some lenders and intermediaries have been exploiting consumers' behavioural biases by increasing mortgage-related charges and selling foreseeably unaffordable mortgages, in particular in the credit-impaired sector.⁴ The combination of consumers' biases and firms' weak incentives to counteract these contributed to unsustainable volumes of high-risk lending and consequent losses for consumers and lenders.
16. Our high-level analysis suggests that competition in the mortgage market is intensive at the level of headline interest rates but may not be so at the level of other related fees and charges. It seems that lenders have been benefiting from consumers' bias towards focusing on the initial cost of the mortgage rather than on the level of add-on fees and charges. This has resulted in firms competing on headline interest rates but relying on the consumer keeping the loan beyond the introductory period to make the loan profitable, and also profiting from add-on charges and fees.⁵ Furthermore, consumers often focus on the short-term costs of having a mortgage and many have relied on short-term deals on the assumption that they will be able to remortgage at the end of the introductory period. They pay less attention to longer term risks to affordability, such as rising interest rates, unemployment and other life events that reduce household income.
17. Consumers in the market seek mortgage assistance from intermediaries in order to benefit from intermediaries' ability to get them a mortgage, shop-around and secure a competitive rate on their behalf, as well as for reasons of convenience and quality of service. However, given that mortgage intermediaries are typically remunerated with a commission or fee at the completion of the transaction, they may not want to consider or pass on to lenders information on the riskiness of the borrowers, and they may attempt to sell foreseeably unaffordable mortgages in order to complete the transaction (i.e. sales bias). The same factors might lead to 'product' bias (i.e. intermediaries selling products with high commission rates), 'provider' bias (i.e. intermediaries selling the products of particular lenders with whom they have special commission agreements) and 'size' bias (i.e. intermediaries selling larger loans than strictly required by the consumer to increase commission), although the evidence is not clear.

3 The concept that a borrower over-extends himself is used here to describe a consumer who borrows beyond his optimum level given his individual characteristics.

4 For a full review of behavioural biases see FSA Consumer Research 69 (2008), 'Financial Capability: A Behavioural Economics Perspective', www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf.

5 Based on the internal FSA research on fees and charges and thematic work on arrears handling in 2008-2009. See also Chapter 6 (section on unfair charges). However, further research on this topic is needed.

18. These biases are not big issues in the prime market because consumers in the prime market tend to shop around and re-mortgage frequently, and this behaviour of consumers ensures that the market delivers relatively competitive products to them.⁶ However, there is some evidence of these biases in the credit-impaired sector. This is mainly due to the behaviour of these consumers, inherited behavioural biases, and their overwhelming reliance on intermediaries.⁷
19. The presence of these biases for intermediaries and the desire of credit-impaired consumers to obtain a mortgage at any cost brought collusion between some in these two groups. The incentives were such that some intermediaries were searching the market for products with the most relaxed eligibility criteria to match the characteristics of credit-impaired consumers, rather than searching for the most suitable and affordable mortgages at the least overall cost. At the same time, many consumers were exaggerating their incomes to qualify for mortgages with the implicit approval (and often help) of intermediaries.⁸ This resulted in sales of unaffordable mortgages with high fees and charges attached.⁹
20. There are other market failures in the mortgage market such as the existence of negative externalities¹⁰ and the existence of moral hazard¹¹ associated with deposit insurance but they are mainly addressed through changes in other areas (e.g. prudential requirements) and are not within the scope of this CBA. These changes are discussed in detail in Chapter 3. However, changes in prudential requirements could impact – at least partially – on some of the issues identified in this paper. For example, if there are changes to prudential requirements for MIPRU-regulated non-banks, these changes could increase entry and exit barriers to the market and change the nature of competition in the market. However, the magnitude of these changes will largely depend on the detailed rules regarding controls on high-risk lenders proposed at the Consultation Paper stage.

Section 2: Overall CBA of the Mortgage Market Review proposals

21. We are aware that some proposals may have little impact on lenders and borrowers at the moment but that this may change in the future once the market has started to recover. For example, following the current global financial crisis, some mortgage products are no longer being sold or have been modified substantially by market participants themselves (e.g. minimal credit impaired and self-cert lending, etc.). Therefore the benefits of the proposals are analysed on the basis that the market has recovered.

6 See 5.43 for details of current net commission rates within the mainstream prime market.

7 Intermediaries handled over 90% of non-conforming mortgage lending at the peak of the market in 2006-2007 (source: PSD).

8 See Chapter 3 (section on income non-verified mortgages).

9 Internal FSA research on fees and charges and thematic work on arrears handling in 2008-2009.

10 Banking failures can impose significant costs on those who are not parties to the transactions that caused the failures.

11 For example: (1) a non risk-based compensation scheme increases the scope for opportunistic behaviour by banks, and (2) the presence of deposit insurance reduces the incentives for depositors to monitor the behaviour of banks.

22. Overall, on the one hand, the package of proposals, if calibrated appropriately, could lead to a reduction in the number of unaffordable mortgage sales and associated costs for borrowers, lenders and the wider economy; on the other hand, if calibrated too stringently, the proposals could limit access to the mortgage market for suitable individuals who could have entered the market.
23. Depending on the specific requirements proposed at the consultation stage, the proposals could have significant macroeconomic implications. Limiting sales of certain products aims to reduce volumes of unsustainable higher-risk lending and the tendency for the property market to deviate significantly from trend (a significant deviation from trend could contribute to a financial crisis).¹² If calibrated appropriately, the proposals will contribute to the stability of the financial system and affect GDP growth in a positive way. In particular, limiting sales of certain products could beneficially reduce the volumes of mortgage lending in the economy. However, if calibrated too stringently, the proposals could negatively affect GDP growth and general living standards. In either case, there could be effects on: (1) demand for housing, demand for rental properties, and related social policies including the home ownership rate; (2) supply of housing, and the prospects for house-builders and related industries, (3) lenders' portfolios and profitability; (4) fiscal policy; (5) monetary policy; and (6) pension policy (as buying a house is often a major source of income in retirement).
24. Moreover, the proposals are likely to impose non-trivial incremental compliance costs on lenders and intermediaries as well as to require additional FSA supervision and enforcement resources to ensure firms are incentivised to comply, which is essential in order for the benefits of the proposals to arise. Therefore, the effectiveness of these proposals will depend on the detailed prescriptive guidelines and the effectiveness of the FSA's supervisory and enforcement efforts, especially during periods of rising property prices.
25. However, it is ambiguous whether the proposals will produce the expected benefits if there is a possibility of gaming any imposed limits. Any limits on what firms and consumers perceive to be mutually beneficial transactions will see attempts to bypass them by both lenders and borrowers through the valuation of properties, unregulated mortgage lending (second-charge mortgages), unsecured loans, etc. The FSA may only be able to partially mitigate this risk.
26. We explain below in more detail how the different proposals contribute to the overall costs and benefits discussed above. To do this we have clustered the proposals into the following broad groups:
 - Proposals on 'product regulation' and 'sales regulation';
 - Proposals on 'distribution and advice'; and
 - Proposals on 'unfair practices and charges'.

12 Barrell, Davis, Karim and Liadze, (2009), "Bank regulation, property prices and early warning systems for banking crises in OECD countries", National Institute Economic Review, <http://www.niesr.ac.uk/pdf/dp330.pdf>

Section 3: CBA of proposals under “product and sales regulation”

27. Table 1 lists the individual proposals that fall into this category. We discuss below their combined costs and benefits.

Table 1: product regulation and sales regulation

Product regulation	<ul style="list-style-type: none"> • Require income verification in every sale (i.e. ban self-cert and fast track). • Ban sales of products to borrowers exhibiting multiple high risk characteristics (e.g. subprime at high LTI).
Sales regulation	<ul style="list-style-type: none"> • Make lender ultimately responsible for assessing affordability. • Prescribe detailed affordability assessment for lenders. • Revised approach to disclosure. • Require affordability assessment on interest-only mortgages to be on a repayment basis. • Set a limit on how much a consumer can borrow relative to their free disposable income. • Restrict the amount of equity a consumer can withdraw. • Strengthen controls on high-risk lenders (e.g. through more stringent assessment of business models).

28. In the recent past some lenders have been taking on unsustainable volumes of higher risk lending and some have been making lending decisions mainly based on the underlying collateral without undertaking a proper assessment of the consumer’s ability to repay the sums lent. The proposals under ‘product regulation and sales regulation’ aim to target the incentives to sell foreseeably unaffordable mortgages and to reduce unsustainable risk-taking during an upswing. In particular, the main benefits arising from these proposals are:

- Banning or limiting sales of high-risk mortgage products will contribute to a reduction in the number of unaffordable mortgages and associated costs for borrowers and lenders. In particular, the proposals will help consumers to avoid overextending themselves in the process of choosing a mortgage product as some consumers will not be able to borrow at all, while others will have to settle for a smaller mortgage;
- At the same time, banning or limiting sales of high-risk mortgage products will prevent or limit their re-emergence in the future once the market has recovered. Volumes of unsustainable high-risk lending (such as self-cert and interest-only) contributed to the high number of unaffordable mortgages and associated costs for borrowers and lenders;
- Banning or limiting sales of high-risk mortgage products will also contribute to the reduction of pro-cyclicality in the housing market and help reduce the tendency for the property market to deviate significantly from trend. For example, an increase in interest-only mortgages without repayment mechanism attached, NIV and high debt-to-income ratio mortgages may contribute to

inflation in the housing market. At the same time, inflation in the housing market stimulates the demand for such types of mortgages, which fuels house price inflation further and eventually could pose a risk to financial stability;

- Our policy approach to date has been underpinned by a view that consumers will react rationally to information made available to protect their own interest. But the evidence from the FSA research suggests that written disclosures¹³ and measures designed to improve financial capability¹⁴ are unlikely to affect firm and consumer behaviour significantly. Proposals that rely less on disclosure as a regulatory tool (e.g. scrapping the IDD) and focus more on other regulatory tools, such as product and sales regulation, are expected to achieve better outcomes for consumers; and
- Prescribing a detailed affordability assessment and clarifying that lenders are ultimately responsible for it will facilitate effective supervision and enforcement and therefore incentivise greater compliance.

29. We set out below the main types of costs that could arise from these proposals. These costs include:

- Incremental compliance costs for firms, for example those necessary to verify borrowers' ability to repay the mortgage (beyond current business practices);
- Specific requirements have not yet been set but could, if unduly stringent, unnecessarily limit access to the market for some customers (e.g. customers who have unusual circumstances, customers with moderately imperfect credit histories, etc.). This in turn will lead to a loss of utility to those consumers who could otherwise have entered into suitable transactions;
- If set too stringently, the proposals could reduce the volume of welfare-enhancing as well as welfare-reducing mortgage lending in the economy and therefore have some negative macroeconomic implications (effect on social, fiscal and monetary policies, etc.); and
- Banning or limiting sales of certain products could negatively affect product innovation in the market. However, the overall welfare impact is unclear as the evidence from the recent past shows that innovations can be welfare-destructive if they lead to unsustainable levels of high-risk lending.

13 De Meza, Irlenbusch, and Reyniers, (2007), 'Information versus persuasion: experimental evidence on salesmanship, mandatory disclosure and the purchase of income and loan payment protection insurance', www.fsa.gov.uk/pubs/other/DeMeza_Report.pdf

14 FSA Consumer Research 69 (2008), 'Financial Capability: A Behavioural Economics Perspective', www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf.

Section 4: CBA of proposals under “distribution and advice”

30. Table 2 lists the individual proposals under this category. We discuss below the potential costs and benefits from their combined effect.

Table 2: distribution and advice

<p>Distribution and advice</p>	<ul style="list-style-type: none"> • Extend approved persons regime to mortgage advisors, arrangers and administrators. • Align scope of service labels for advised sales with the RDR. • Impose a basic affordability and appropriateness test across all sales. • Include stress testing in the intermediary affordability checks. • Adoption of professional standards as set out in the RDR, such as a code of ethics, firm-led CPD initiatives and individual registration of advisers by the Professional Standards Board.
---------------------------------------	---

31. The proposals under “distribution and advice” seek to address consumers’ limited ability to differentiate between good and poor quality sales staff. In particular, the main benefits arising from these proposals are:
- Moving to a basic affordability and appropriateness check in non-advised sales could bring some benefits in terms of a reduction of “clear-cut” unsuitable sales;
 - The proposals to extend the Approved Persons regime to mortgage advisers and arrangers, register advisers with the Professional Standards Board, and introduce a Code of Ethics aim to improve standards of fitness and propriety among individual mortgage advisers and prohibit rogue individuals from the industry. This could bring a reduction in fraudulent behaviours in the market, leading to an improvement in the quality of advice and sales, thereby improving the suitability of consumer purchases.
 - The alignment of scope of service labels with the RDR should minimise the risk of consumer confusion about the level of service they are receiving; and
 - Overall, these measures should facilitate effective supervision and enforcement and therefore incentivise greater compliance.
32. The main types of costs that could arise from these proposals include non-trivial compliance costs for firms and supervision and enforcement costs for the FSA for registering Approved Persons, and monitoring and enforcing the Approved Persons regime and the basic affordability and appropriateness tests. Moreover, the proposals could increase entry barriers and costs of doing business in the intermediated market, and consequently reduce the supply of advice in the market.
33. The effects of these proposals on the quality of advice and information-only sales by mortgage intermediaries will largely depend on the effectiveness of the FSA’s supervisory and enforcement efforts.

Section 5: CBA of proposals under “Unfair practices and charges”

34. Table 3 lists the individual proposals under this category. We discuss below the potential costs and benefits from their combined effect.

Table 3: Unfair practices and charges

<p>Unfair practices and charges</p>	<ul style="list-style-type: none"> • Ban the continued application of the monthly arrears administration charge where a consumer is adhering to an arrangement to repay arrears. • Ban the charging of Early Redemption Charges on arrears fees and charges, and limit ERC advances. • Convert MCOB 13 forbearance guidance into rules and add relevant information on the Government’s scheme. • Wider investigatory work into the level of arrears charges. • Enforce existing excessive charges rule. • Ban roll-up of fees into a loan.
--	---

35. The proposals under ‘unfair practices and charges’ aim to reduce consumer detriment arising from consumers’ bias towards focusing on the headline mortgage interest rates rather than taking appropriate account of the level of add-on fees and charges. In particular, the main benefits arising from these proposals are:

- Proposals for improving handling of arrears and repossessions could reduce detriment to consumers in financial difficulties due to unfair practices employed by some lenders. However, whether the proposals will produce the expected benefits will largely depend on the effectiveness of the FSA’s supervisory and enforcement efforts.
- Enforcing charging rules could reduce the level of these charges and the ability of lenders to cross-subsidise between different types of consumers. However, any limit on the level of charges may create incentives for firms to recover revenue lost through other means (e.g. increase headline interest rates or introduce new fees/charges).
- Banning the rolling-up of fees into the mortgage aims to increase consumers’ focus on the level of fees and charges but could limit access to the market for some customers. Further analysis needs to be undertaken to assess the costs and benefits of this proposal.

36. Besides non-trivial compliance costs for firms, the main types of costs that could arise from these proposals include:

- Costs for the FSA associated with taking price into account in assessing suitability, such as costs associated with data collection, analysis, monitoring, and resources spent on dealing with individual firms; and
- Costs for firms associated with taking price into account in assessing suitability, such as costs of production and reporting of relevant price and cost data, and resources spent on dealing with the FSA.

Section 6: Transition and timing issues

37. The proposals in this Discussion Paper are designed to have a positive impact across the economic cycle. However this discussion is happening at a time when the prospects for the economy are unclear. While there are some early signs of recovery, the path we will take to an economic recovery is very uncertain. Consequently, it will be important for us to monitor closely the development of economic conditions as we develop and implement the proposals and to look carefully at how they would operate in various future economic scenarios.
38. We recognise that the timing of the implementation of each element will be crucial in determining the effectiveness of the overall package. For example, some of the discussion focuses on intentionally restricting high-risk lending. In the current subdued market, with lenders already imposing significant restrictions, the changes may initially have little impact. However, imposing such changes once the mortgage market has substantially recovered may act as a significant negative shock to the development of the market. Imposing additional costs on firms when the market is subdued may also have a disproportionate impact on firms. There is a careful balance that needs to be drawn here to introduce changes at the right time.
39. In some areas we will need to take a flexible approach, introducing some elements at an early stage, with others following on once we have fully investigated the issues and developed the response. For example, we are proposing to introduce some of our proposals for improving handling of arrears and repossessions and banning some of the unfair charges imposed by firms quickly to address immediate issues in the current environment. However, other actions, such as the proposal to prohibit sales of products that have multiple high-risk characteristics, will require detailed and careful analysis and will take longer to implement.
40. Firms and consumers may change their behaviour in anticipation of our proposals being introduced. This could have a significant impact on the market in the short-term and we need to be cautious of any resulting negative effects. Where these risks are identified, we will need to carefully coordinate interventions with the recovery of the market and seek to balance the various tensions between the objectives for this review.

PUB REF: 001798

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: <http://www.fsa.gov.uk>

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.